

FAMILY LIMITED PARTNERSHIP

The Family Limited Partnership is simply a partnership in which all or most of the partners are members of the same family. The Family Limited Partnership is one of the most flexible tools that can be used as a part of an estate plan. Its most widely known benefits are its tax savings uses and its asset protection benefits. However, the benefits are more extensive than just those listed above.

Family Limited Partnerships have been marketed for years as an asset protection vehicle. However, they are also coming into their own as an excellent tool in a broad range of financial plans. *Forbes* magazine (June 1993) highlighted the family limited partnership as "a clean way to keep control of the family business, protect assets and duck big estate taxes." OK, How, When, What's the Catch -?

A Family Limited Partnership is simply a limited partnership in which all partners are family members. The assets owned by the partnership are assets formerly owned by individual members of the family. The assets consist of any assets of the family including commercial real estate, a ranch or other acreage, vacation homes, marketable securities, bonds and investment partnerships. Usually the partnership does not own an active trade or business.

To understand how the partnership operates and the benefits to be derived from its use, it is helpful to begin with a discussion of limited partnerships in general. A limited partnership is a creation of statutory law. Partnerships, (frequently now referred to as general partnerships to distinguish them from limited partnerships) have been in existence as long as there have been two

or more individuals in business together. The law interpreting partnerships was developed through case law generally arising out of a conflict or falling out between the partners. A general partnership was deemed to be formed whenever two or more people got together to carry on any activity for profit. Every partner had control and every partner was liable for the debts of the partnership.

A "clean way to keep control of the family business, protect assets and duck big estate taxes." *Forbes*.

Let's look at why we might not like that. Suppose that Darcy had an idea for a new hearing aid, but did not have the funds to market the hearing aid. Lee, a business acquaintance, has the funds to market the product. Lee is willing to finance the operation but does not want to be liable for the debts of the business. Darcy and Lee could form a corporation to market their business. Neither Darcy nor Lee would be personally liable for the debts of the business. But, there is a trade off. In a *partnership*, the owners (partners) are taxed on their share of the profits. In a *corporation*, the owners (shareholders) are taxed on any amounts they take out of the corporation as salary, but the

corporation is taxed on the profits. If the owners wanted the corporation to distribute the profit to them as a dividend, the dividends would be taxed to them also.

Darcy and Lee want to avoid this double tax, yet retain the benefit of limited liability. In response to people like Darcy and Lee, two changes occurred one in the tax law and one under state law. The tax code allowed the shareholders of a corporation to elect to be taxed individually on the profits of the corporation. These corporations are referred to as S corporations. States responded by creating a different type of partnership, a limited partnership. Until 1997, it was important to structure the limited partnership so that it had more characteristics of a partnership than a corporation so that it would be taxed as a partnership. Beginning in 1997, the partners can simply "check a box" on the partnership's tax return to make this election.

The limited partnership has two types of partners, general partners and limited partners. The general partner has control over the partnership and manages the partnership. Also, the general partner is liable for the debts of the partnership. The limited partner is a passive owner. The limited partner has no liability but also has no control over the partnership. Unless the partnership agreement provides otherwise, the profits of the partnership flow through to the partners in proportion to their ownership interest in the partnership. Ah, now we have an entity that will work well for Darcy and Lee. Darcy is the one who has the concept and will manage the business; therefore, she will be the general partner

and will have control over all operations. Darcy will also receive a salary in payment for her services. Lee is putting up the money and wants to receive three-quarters of the profits. Therefore, Lee will be a limited partner and will own 75% of the partnership. Darcy will own 25% of the partnership as general partner.

A partnership, both general and limited, is a very flexible business planning tool. In structuring a family limited partnership there are two areas that must be considered. First, since the limited partnership is a creation of Texas statutes, one must comply with the state's requirements. For example, a certificate

A partnership...is a very flexible business planning tool.

of limited partnership must be filed with the Secretary of State and a filing fee of \$750 must be paid. The second area that must be considered is the proper administration of the partnership. If the partnership is not treated as a separate entity and the partnership matters handled according to the terms of the agreement and state law, the entity will not be recognized. If the entity is not recognized, the creditor protection benefits are lost, the control over the assets may be lost, and the estate tax savings benefits highlighted in Forbes will not be available.

OK, so just how does this have anything to do with estate planning? Although it is not the most dramatic or the sexiest, the partnership provides a method of providing unified management and investment of a family's assets, maintaining control of assets given to your

children, and providing a management vehicle in the event of your disability, to name a few. But, let's look at what would cause a planner to refer to the use of the partnership as "shrewd." The "shrewd" estate planning benefit is having the benefit of say \$4 million but only paying

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taxes on say \$2.4 million. Suppose you and your spouse have \$4 million in assets and want to sell me one-quarter of your assets. Presumably, I will pay you \$1 million for those assets. Now, let's assume you form a limited partnership. You are the general partner; you and your spouse are the limited partners. You now offer to sell me a 25% interest in that limited partnership, making me a limited partner. Those assets are not worth \$1 million to me. Why? As a limited partner I cannot reach those assets. I cannot decide to sell any of the assets and purchase other assets. As a limited partner, I have no control. You, as general partner, control the partnership. You can decide to sell some assets and buy others. You can decide whether to distribute any of the income or cash in the partnership. You may decide to reinvest all of the income received by the partnership. So what can I, a limited partner, do?

- < I can hope I do not need you to buy me out before the partnership is liquidated.
- < I can hope I do not need you to distribute the income.

- < Even if I do not receive it, I must report 25% of the income on my tax returns since the income of a partnership is taxed proportionately to the partners.
- < I can look at the books and records.
- < I can hope that you manage the partnership wisely so that I will receive much more than the \$1 million upon dissolution of the partnership.
- < I can hope I do not need the money for my support or to pay my taxes.

So, what is it worth to me? The valuation experts discount the value of this partnership interest by 20% - 60%. Therefore, I would pay you between

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\$400,000 and \$800,000 for the 25% interest. Hmm, you are saying - this is an advantage? Absolutely. You form and fund the partnership with investments, cash, a business, real estate, etc. which you intend to keep within the family. Now, let's say you want to give part of the partnership to your children. For example, you want to give your children the same 25% of your estate that you offered to sell to me. However, if you give them 25% of your \$4 million in assets, you would have given them a gift valued at \$1 million. Now, if you give them a 25% interest in a \$4 million partnership, it is valued at 20-60% less than that. Let's assume that the discount is 40%. You will have given them a 25% interest, but the gift would only be valued for tax purposes

at \$600,000. Ah, very good. Yes, this discount can be an advantage.

What about the remaining 75% interest belonging to you and your spouse? What is it worth? It is a majority interest and you are the general partner and have control, does that mean that the value of your interest is worth the full \$3 million?

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No. Why? In a family limited partnership, all partners are required to agree to liquidate the partnership. Therefore, an individual partner's control is limited. Also, you own two types of interest, a limited partnership interest and a general partnership interest. The limited partnership interest has no power, no control; therefore, its value is discounted, just like the limited partnership interest you gave to your children. The fact that you are the general partner will affect the discount and if no successor general partners are named in the partnership agreement will probably eliminate the discount. The limited partnership dissolves under state law if the general partner withdraws. To avoid the dissolution of the partnership, successor general partners are always appointed. In addition, it is preferable to have an entity as the general partner of the partnership to avoid these issues. The entity is generally a limited liability company or S corporation which is owned by you and other members of your family.

The general partnership interest will probably not be discounted; however, you only own 1% of the partnership as a

general partner. Therefore, it is possible that by creating the partnership and transferring a portion of your assets to the partnership that you have reduced the value of the assets held in the partnership by 20 to 60% for estate tax purposes. In our example, using a 40% discount, \$4 million in assets are reduced by \$1.6 million to a value of \$2.4 million. This is a savings of hundreds of thousands of dollars, perhaps even a million dollars in estate tax.

The discount now seems like an advantage, but there is a trade off. Under current law all assets held by an individual or otherwise included in his/her estate upon death receive a basis adjustment to the value of the assets as of the date of death. The basis adjustment is generally referred to as a "step up" in basis since most assets have appreciated in value. This basis adjustment is particularly favorable in a community property state since both halves of the community receive an adjustment to basis on either of the spouse's death. Let's look at our couple with \$4 million in assets. Let's assume that these assets are highly appreciated and have a basis of \$500,000. In our example we illustrated the discount as \$1.6 million. Let's compare the impact on the couple if one of the spouses died and no partnership was formed to the treatment if one of the spouses died immediately after the partnership was formed. If no partnership had been formed the surviving spouse would have \$4 million in assets which received an adjustment to basis up to the \$4 million value of the assets as of the date of one of the spouse's death. If the partnership had been formed, the partnership interest would not be valued at \$4 million. If the partnership interest is

discounted to \$1.6 million, then the basis in the partnership is increased to the \$2.4 million date of death value. \$1.6 million in basis adjustment is lost. You might be thinking that the capital gains tax is much less than the estate tax, but there is no estate tax savings on one spouse's death unless the deceased spouse does not give the amount in excess of the exemption to other individuals. The larger the exemption is the less likely it is that the discount will provide any estate tax savings.

Let's say the benefit from the discount is very attractive to you. Maybe because you are single with a large estate. Are these benefits guaranteed? No. As you might expect, the IRS is not pleased with the dramatic benefits gained from the family limited partnership. But, it is not an aggressive tax "gimmick." The benefits are real, because the reduced value is real. I will not buy a 25% interest in your family's limited partnership for 25% of the value of the underlying assets, nor will anyone else. However, as you may have guessed, the benefits are so dramatic that the IRS may convince Congress to change the law to eliminate this benefit. In fact, a treasury proposal was included in the 1998 Clinton budget proposal to eliminate discounts on all family limited partnerships except those that conduct an active trade or business. As you are aware the shift is now toward a reduction of estate taxes, so any kind of change in the law restricting the use of family limited partnerships is unlikely, but this proposal by the IRS is reflective of the IRS' attitude about the use of family limited partnerships.

And if you (or your spouse or child) went into an audit and looked at the IRS

examiner, laughed, and said "We did it solely to reduce the amount of money my family would pay you guys", the IRS examiner would probably have the last laugh by throwing the partnership out as having no business purpose.

So do you create a partnership for this sole reason? No. Although the dramatic tax savings benefits may be the aspect of the partnership that first got our attention, it is the other benefits of the partnership that reward us on a daily basis and are the real day-to-day reasons to have the partnership. What are some of those benefits?

- < Asset protection is one.
- < The big "C" - Control, is another.
- < Unified management of the assets is a third.
- < Giving an undivided fractional interest in all assets rather than selecting specific assets to use in making gifts.

Unified management is lumped with control in some of our minds - in other words, aren't we wiser than our children in management and investment of our assets? But also, larger sums of money and assets can be managed more efficiently and economically than small ones. The benefits of unified management apply to most assets including oil and gas, real estate and investments.

Let's first look at how the partnership might work for a family that has a trade or business. In our example above, Darcy had an idea for the development of a new hearing aid. Lee provided the money

necessary to market the interest. Now, let's assume Darcy's business was successful and she bought Lee's interest. Darcy is now operating the business by herself. Darcy and her husband, Jamie, could form a limited partnership with Darcy as the general partner and Darcy and Jamie as the limited partners. Darcy

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could own all of her interest as a general partner, but for a couple of reasons will want to own part of her interest as a limited partner. Let's assume that Darcy owns 1% of her interest as general partner and 49% of her interest as limited partner. Jamie owns his 50% of the partnership as a limited partner.

Darcy and Jamie have two children: Alexander and Kate. Darcy and Jamie want to begin to provide some savings for their children's future. Darcy and Jamie can give their children limited partnership interests. The gifts can be to a trust for their children or to their children outright, depending upon the age of their children and their other estate planning objectives.

Assuming that they give their children the interests outright, their children will be receiving the benefit of the gift in the sense that their children will receive that

...there are many reasons we might want to use a partnership - some relate to the dynamics in our family and some relate to the nature of our assets.

portion of the partnership at the time the

partnership is terminated. However, at the present time, Darcy maintains full control over the management of the partnership and over the distribution of any of the income or other cash of the partnership.

What if Alexander and Kate spend everything they make on high living? No problem, the partnership interest is not liquid and cannot be sold due to restrictions in the partnership agreement. What if Darcy wants Alexander and Kate to receive some income from the partnership? She can distribute cash to them each year, so long as the distributions are made proportionately to all partners.

What if the family has no active trade or business and wants to transfer their investment assets (real estate, oil and gas, stocks, bonds, Treasury Bills and cash) to the partnership? Can they do this? Yes. And there are many reasons we might want to use a partnership - some relate to the dynamics in our family and some relate to the nature of our assets.

Let's be realistic. We love our families, but we are human. We have our weaknesses, idiosyncrasies and our conflicts. Sometimes a family member has financial problems. Sometimes a family member is divorced, maybe amicably, maybe not. Sometimes a family member is disabled. Some family members have business and investment expertise, some do not. Sometimes we all get along, sometimes we do not. Sometimes a member of the family refuses to cooperate with other members of the family -- whether for the sake of the battle or their need for money. So the

differences in each of us as humans, sometimes minimized, sometimes exaggerated by family interaction, is one reason.

Another reason is that our estates are, and should be diversified. We don't own

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only one asset. We might own some real estate, some oil and gas and some stocks. Within each of these categories, the nature of the asset may vary, the real estate might be raw land, an office building or a rent house. The oil and gas might be working interests or royalty interests. The stocks may be aggressive growth stocks or blue chip income stocks. We may own bonds or international equities.

We may have one child who can manage the real estate or the oil and gas or the investments. Another may not have that talent. Even if our children's talents and propensities do not differ, we may want to treat our children equally and give each a small piece of the whole rather than picking a particular asset to give each

Management, purchase and sale decisions are made by the general partner.

child. If we give our children each a fraction of a piece of real estate or of an oil and gas interest, we may be creating an administrative nightmare - who manages the property, how are the taxes paid if there is no income, who makes decisions concerning the sale of the

asset? Clearly, some assets create more problems than others.

So, how does the family limited partnership help with these issues?

- < The administration of the family's assets can be handled by you or by a team consisting of one or more members of your family.
- < You or your team are the general partners of the partnership.
- < Management, purchase and sale decisions are made by the general partner.
- < Conflict is reduced.

The partnership may only be owned by the parents and their descendants or may include spouses of their descendants or charities. If a member of the family is divorced, the partnership agreement can prevent the partnership interest from passing to the estranged spouse in the divorce.

Gifts can be made of the partnership interests rather than of the individual assets. If you and your spouse are disabled, you can provide for another member of your family (or a team or a non-family person or entity) to manage the partnership. The partnership facilitates the transfer of the property in the event of the death of a partner. The transfer is of a limited partnership interest rather than individual assets.

The partnership can also be used to educate the family about the portion of the

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family's wealth held in the partnership. The partnership can provide a vehicle to promote communication and education about the administration, investment and disposition of the family's assets. This aspect can be used as much or as little as the family desires.

Another by-product of our high divorce rate and quick-to-litigate temperament is an increase in the likelihood that a Will contest will be filed. The use of a limited partnership is another tool in our box of tools to make a Will contest less profitable; therefore, less likely. If a limited partnership is created as a part of an estate plan, the major asset held by the estate is a limited partnership interest. Therefore, even if the contest were successful, all the contestant would receive is a limited partnership interest.

And what about the prepackaged plans? My experience has been, depending on the cost, they are either an expensive mistake or a false economy. The family limited partnership is and should be an integral part of your personal financial plan. If you decide to utilize one, bring in all the members of your team - your attorney, your accountant, your financial advisor. Make sure the partnership serves purposes in your estate plan other than possible tax savings. Make sure its creation and funding are well thought out and personalized. Make sure the funding is properly handled. Recognize that the partnership is a separate legal entity from yourself.

The benefits day to day may not be the ones that caused you to create [a limited partnership], but they are the ones that make you glad you did.

The more I work with family limited partnerships, the more uses I see for them and the more flexibility I realize they have. The glitz and glamour is in the asset protection benefits and the estate planning benefits. Control is retained. Creditors cannot reach the assets. Estate taxes may be dramatically reduced.

Estate tax reduction and/or asset protection may be the benefits that cause you to consider the family limited partnership; however, if in the day-to-day administration of the partnership, the partnership structure runs contrary to your overall personal, family wealth and business planning objectives, you will hate it. If asset protection or estate tax reduction is the sole benefit, do not do it.

Be careful to structure the partnership so that it accomplishes your personal and family objectives on a daily ongoing basis. If you want to use the funds for your daily living expenses then structuring the partnership so that no income is distributed would not suit your personal situation. You retain control over the assets but if you want your children to have access to their share of the funds, then the partnership may not serve your purpose. The benefits you will gain day to day may not be the ones that caused you to create it, but they are the ones that make you glad you did.

And, what if you hate it? If you and your family wish you had never created the partnership? The partnership can be liquidated upon the vote of all the partners.

Administration of the Partnership - The Proof is in the Pudding

Let's assume you decide that the partnership would accomplish your objectives. You have decided to form the partnership. You like the tax benefits, but you also want the asset protection and the control. You have signed all of the documents. Now you can proceed as always, right? A resounding "NO."

- < The property is no longer your property.
- < The money is no longer your money.
- < The income is no longer your income.

But, you created it to maintain control. What has gone awry here? You must respect the partnership as a separate person, a separate entity.

An illustration. Mom formed partnership with children. Mom transferred all of her property to the partnership. Mom gave most of the interests in the partnership to her children. Mom wanted the income on the assets. Her children could have the property as far as she was concerned. Mom collected all of the income from the assets and deposited the income in her personal bank account.

A problem? Big problem. First, this situation is an actual case. The IRS won. All of the property was included in Mom's estate. No discounts.

But this treatment is not just a tax problem. If a creditor had sued Mom, the creditor could have thrown the partnership

out. The income was not Mom's income, it was the partnership's income. So, Mom's children could have sued Mom.

Formalities are important. Proper administration is important. A good CPA is essential.

Let's look at another example. Son-in-law has heard about the fantastic tax savings on the use of a partnership. His wife's father is seriously ill and son-in-law has a power of attorney for his wife's father. Son-in-law forms a family limited partnership and transfers all of his father-in-law's property, including his home, to the partnership. Uh, oh ... now his father-in-law needs money. Let's assume son-in-law knows about the case I mentioned above, so he does not want to deposit the income in his father-in-law's personal bank account. No problem we'll just pay those expenses and treat them as distributions to the father-in-law. And wait.. isn't father-in-law living in the house owned by the partnership. Solution have father-in-law pay rent on the house. Wait .. he doesn't have any money. Okay ... "accrue" rent on the books and have him "pay" it when distributions are made from the partnership. In fact, no rent was actually paid until a couple of years after father-in-law's death. Several months later, father-in-law dies. This case was in litigation for several years. The taxpayer won on all the issues raised by the IRS as to the validity of the partnership entity itself. However, the IRS ultimately won on the issue of whether the father-in-law actually gave up anything when the partnership was formed. The court found that there was an implied agreement that the father-in-law could have anything he needed from the partnership and held that all of the assets in the partnership were

included in the father-in-law's estate at full value.

Pigs get fat, hogs get slaughtered. Bad facts make bad law. This case frustrates me because the court saw the actions as abusive by the taxpayer and sought to eliminate this situation from reoccurring. Unfortunately, the court sought to also include the assets in the father-in-law's estate by virtue of the control that the father-in-law had through the general partner. Time and additional cases will provide us with the impact of this holding.

Rules of thumb:

- < Do not transfer all of your assets to a family limited partnership.
- < Do not transfer your home or other personal use assets such as a car to the partnership.
- < Transfer all partnership assets into the partnership name.
- < Open a partnership bank account and if applicable, a partnership brokerage account.
- < Only the general partner can act for the partnership.
- < Sign contracts, agreements, checks, etc. only as the general partner.
- < If the general partner is a corporation, sign only as an officer of the corporation. If the general partner is an LLC sign only as a member of the LLC.

< Deposit all income to the partnership account.

< Pay all expenses on partnership assets and for partnership administration from the partnership account.

< NEVER MAKE A DISTRIBUTION TO ONLY ONE PARTNER.

< All distributions must be made proportionately to all partners. For example, you own a 1% interest as general partner, a 40% interest as limited partner, and your spouse has a 41% interest as limited partner. Each of your three children, Connor, Soren and Sydney have a 6% interest. If you distribute \$100, you must distribute \$41 to yourself, \$41 to your spouse and \$6 each to Connor, Soren and Sydney.

Your financial statement should reflect that you own an interest in the family limited partnership, not the assets held in the partnership.

When you make a gift of a partnership interest, you must change the persons to whom you distribute income thereafter.

If you contribute property to a partnership, it either increases your interest in the partnership or is a gift to the other partners.

If you have any doubt concerning the handling of an income item, an expense or a distribution (or any other matter relating to the partnership) call your accountant or your attorney. Frequent contact with your accountant is very

important. Contact is particularly important when the partnership is first formed and you are handling items for the first time.

EXAMPLE - EXAMPLE - EXAMPLE THREE FAMILIES - THREE USES

This section is an illustration of the use of a family limited partnership for three different fictitious families. I have made them somewhat less complex, losing some of the depth of the families and the intricacies of the use of partnerships - but,

The Epsons - a blended family - \$25 million estate, owing \$11 million in estate taxes

after all this is a simply an illustration, not a novel. Now, let's see how three different families might use a family limited partnership as a part of their estate plan.

Many families today are faced with the complexities of a blended family, yours, mine and ours. Let's see how the Epsons resolve some of the issues of gift and estate planning for their blended family.

THE EPSONS

George and Denise Epsen have both been married before. Their family is a blended family with his children, her children and their children. George is 65 and Denise is 55. They were married 20 years ago. At the time of their marriage, Denise had one son, who is now 30 and George had two children, a son and a daughter who are now ages 33 and 35, respectively. The Epsens had one daughter who is now 18 years old.

George's son is somewhat of a free spirit. He is currently a ski instructor in Aspen. George is close to his daughter who is married with two children. Denise's son has an MBA and is currently working with

The Partnership...helps address issues in blended families.

a small company where he began on the ground floor. The Epsen's daughter is a freshman at Rice and is interested in Engineering.

George has separate property currently valued at \$12 million. His properties include a ranch and oil and gas interests, both working and royalty interests. Denise has separate property consisting of \$3 million in bonds and marketable securities. The Epsens have community property of \$10 million consisting of about \$2 million in oil and gas interests and the remainder in real estate and mortgage notes.

George wants to leave his separate property and his one-half of the community to his two children by his first marriage and his and Denise's daughter.

... facilitates management of "messy" assets

Denise wants to leave her separate property and her one-half of the community to her son and their daughter equally. They each want the survivor to have the use of the community property for his/her lifetime. George is concerned about the management of his oil and gas interests, his real estate and his mortgage notes. Most of the oil and gas and real

estate is located in Texas, but some of each of them are located in other states. He would like to begin to convert the real estate and mortgage notes to cash and invest them in a more easily managed investment portfolio. However, he anticipates that the process will take years to complete. George feels that the oil and gas interests are good investments and should be retained; however, he feels that the continuous division of these assets by giving undivided interests to his children will be expensive and cumbersome. He also is concerned that the assets will not be managed to maximize their value.

Now let's look at the issues that George and Denise are dealing with and how a limited partnership might be a useful tool in their situation. Clearly George and Denise have an estate tax problem. They will owe over \$11 million in tax on their combined estates. In their blended family

...lets you make gifts while continuing to control the management of the property given

situation, one or more members of the family may complain about the amount of property their "side" receives. The properties require management and may suffer upon George's disability or death. The property is not easily divisible among the family members. Division of the property is likely to cause disputes, cause a diminution in value and be expensive. The transfer of the properties upon George's death, Denise's death and to or among various trusts and the children is likely to be expensive, further consuming a portion of the estate.

Enter the family limited partnership to address these concerns.

Disputes Concerning the Character of the Property

You are probably wondering why anyone cares. Well, let's think about the impact. Let's assume that George and Denise die in an accident. Denise gives her half of the community and her separate property to her two children. If George and Denise have \$10 million in community and Denise has \$3 million in separate, her children will receive \$8 million less the taxes owed. But what if they were able to prove that George had no separate property, that he only had community property? Then the community estate would be \$22 million and Denise's children would receive half of the \$22 million plus her \$3 million, increasing their share from \$8 million to \$14 million.

Could this happen? Certainly! Income on separate property is community property in Texas and when separate and community property are mixed together the property all becomes community. The parties can try to trace the separate property through various changes, but, what does that sound like - conflict, litigation, accountants, attorneys, expense, expense, expense. The answer - avoid it.

In this case, the Epsons decided to form three limited partnerships: one to own the community property, one to own George's separate property and one to own Denise's separate property. George and Denise can enter into an agreement which will clean up the characterization of their property and will avoid any issues concerning the character of the property

in the future. In addition, the limited partnership entities facilitate the separation of the various types of community property. By keeping their property in separate partnerships they can clearly identify which children receive which property both upon their death and in making gifts during their lifetime.

Management

The Epons are also concerned about the management of their property now and in

...minimizes estate taxes

the event either or both of them become disabled. They could use a power of attorney and give one or more persons the authority to manage their property. However, powers of attorney have several problems. First, third parties are frequently apprehensive about accepting a power of attorney as sufficient authority to allow the agent to act. Although these concerns can be overcome, the hassles can become a genuine problem when multiplied by the number of assets (and therefore the number of third parties) that a person may be dealing with. In addition, a power of attorney gives the agent the power to act without reporting to anyone. This fact can cause suspicion and conflict unless the agent keeps good records and is very open with information concerning the management of the disabled person's affairs. The use of a limited partnership can avoid those problems in the management of an extensive portfolio of investments and more particularly in any business or investments which require active management such as certain types of real estate and oil and gas investments. The

person who is selected to manage these investments during disability, can be named as a successor general partner in the partnership agreement. Another method of managing the partnership is to form a corporation and have the person(s) selected to manage the property be officers, directors or employees of the corporation. The use of a corporate general partner allows greater flexibility in selecting persons to manage the property in the future.

Minimizing Transfer Costs

Transferring real estate can be time consuming and multiple transfers can begin to get expensive. However, oil and gas interests are much worse as they are likely to be in smaller interests. Not only must legal title be transferred, but all paying parties must be notified, transfer documents must be signed and all other requirements must be met. The cost and partnership hassle involved can be staggering. By transferring these properties into the partnership, the transfer need only be made one time. Thereafter, the interests are transferred and not the underlying assets or a fraction of any of the underlying assets. The children do not have any rights to the underlying assets, they only have an interest in the partnership as a whole.

Avoiding Fractionalization of Assets

If the real estate, oil and gas and other assets are owned outside of the partnership, the property can be divided one of two ways. Either every beneficiary can receive a fraction of every asset - (groan, need I say more about the expense and hassle that would involve?) or some beneficiaries can receive some assets and other beneficiaries can receive other assets. As long as all the assets are identical in terms of type of investment, appreciation potential,

The estate tax savings on this reduction could be in excess of \$5.5 million.

expense in maintaining, management requirements, etc. and/or all parties agree on all matters - no problem. But sometimes, homogeneity and harmony are not to be had. Unfortunately, death and money can change people in unexpected and undesirable ways, so even if the parents cannot imagine a problem, one can occur. However, many parents can foresee a problem and any structure that can eliminate these issues is a prudent choice.

Avoiding Out of State Probate

If real estate and oil and gas are owned in a limited partnership, the property is considered personal property - not real property. Personal property is subject to probate in the state of the deceased person's residence, not in the state where the real property is located. By transferring out of state real property to the partnership, you can eliminate probate in those other states.

And Estate Taxes?

Yes, there are some benefits there too, but the benefits we've already mentioned

...reduces the power and possible manipulation of an errant or disinherited child

were the ones that motivated the Epsons to create the partnerships. But, let's look at how the partnerships might also benefit them from an estate tax perspective. Assuming that the Epsons transfer all of their property to these partnerships, the partnerships will own a total of \$25 million in property. As mentioned above, the value of a partnership interest is discounted 20% to 60% in value. If the partnership interests are valued at 40% less than the underlying assets, the use of the partnership will reduce the value of their combined estates by \$10 million. The estate tax savings on this reduction would be \$4.5 million to \$5 million unless the Epsons died in 2010. They can further reduce their estate tax by making annual exclusion gifts of partnership interests to their children or by establishing a GRAT.

But .. the Epsons pay a price for the estate tax savings in that the Epsons will lose part of the step up in basis on the death of the first spouse on all of the community and on the deceased spouse's separate property. This trade off can be very significant.

A family may have an errant child who has demonstrated irresponsibility with handling money. The Wights were at their wits end with this child and wanted to leave only a small amount to this child to

avoid his squandering the estate they had worked so hard to create. To do this, they needed planning to direct the assets to the more responsible children and to manage any assets the errant child may obtain.

THE WIGHTS

Jack and Karen Wight, ages 62 and 60, have been married for 40 years. They have three children, ages 28, 31 and 35. Jack is a doctor and is still actively practicing as an anesthesiologist. Karen is a sculptor. They have a community estate of \$5 million. Their estate consists

The Wights - a doctor, a sculptor, \$5 million - "Con man" son - \$2.2 million in estate taxes

of a ranch valued at \$2 million, a home valued at \$500,000, a pension plan valued at \$1 million and \$1.5 million in other assets. The 35-year-old son, Sam, is a con man. He has a different idea/scheme each week and does not seem to have any conscience about his victims. Sam convinced his 84-year-old grandmother to invest all of her savings of \$140,000 in his new business venture which turned out to lack substance and backing. To soothe his concern over his failed venture, Sam took a leave of absence from the family and traveled for a year. Jack is extremely concerned about Sam's behavior and wants to prevent him from influencing his brother and sister, and wants to cut him out of his Will. Karen is not sure whether she wants to cut Sam out altogether, but if she does leave him anything, she wants it to be a small share. She is hoping that a small bequest would keep him away from the

family for a while. Jack has never been sued, is not aware of any problems, but is anxious about all the lawsuits against doctors which he has heard about. Jack and Karen love the ranch as do their 28- and 31-year-old children, Reagan and Sarah. Sarah has one child, Ethan, who is 9 years old. The Wights have put \$100,000 in a UGMA account for Ethan. Although Ethan is still young, the Wights are concerned that allowing Ethan to receive the \$100,000 at age 21 might be a disincentive to furthering his education or, even worse, finance an errant lifestyle. Their experience with Sam certainly hasn't helped alleviate their concern.

Although their estate is large, the Wights do not feel comfortable making significant gifts to their children at this time. They would like to make gifts if they could keep the control and use of the property during their lifetime. The Wights objectives are to protect their assets, disinherit their son, make gifts of their property without diminishing their retirement resources and keep the ranch in the family.

Asset Protection for the Wights

The Wights can use the family limited partnership as an asset protection device as discussed in the chapter titled "Asset Protection." Although the limited partnership does not provide complete protection, it does convert desirable into undesirable assets for creditors. For the same reasons that a partnership interest is discounted, the interest is not as attractive to a creditor. In addition, the parties controlling the partnership are even less inclined to make any distributions while a creditor is holding the partnership interest. Few creditors want to be in this position.

Disinheriting Sam

Sam is a con man. He does not shy away from conflict. If disinherited, it is likely that he will contest the Will. Jack and Karen may want to leave Sam a very reduced bequest which would be eliminated if he contested the Will. The partnership provides some additional protection. If Sam does contest the Will, if all of Jack

...discourages Will contests

and Karen's property is owned by the partnerships, all Sam will receive is a limited partnership interest. He will have no control over the partnership and will not be able to force a division or distribution of the property. The use of the partnership therefore may facilitate a settlement or even discourage Sam from filing the contest.

Gifts to Children

By transferring the ranch to a partnership and managing the ranch through the partnership, Jack and Karen can retain control over the ranch and use the ranch. They can give limited partnership interests to Reagan and Sarah each year.

The management and other benefits mentioned in our discussion about the Epsons apply to a lesser extent with the Wights.

Control UGMA Money

If the funds held for Ethan are invested in the family limited partnership, he will benefit from the diversification of the investments. In addition, he will not be able to squander or consume the money

when he reaches 21. If the Wights want Ethan to have the funds for college, or starting a business, or something else other than a "higher standard of living," the Wights can purchase his interest at that time.

Another concern and a different perspective from the Epsons and the Wights involve single adults. Consider Monica's position; she is a single parent with three children to raise and provide for. She is about to patent a new product

...helps protect assets from creditors...or a new spouse

which has the potential to earn a large revenue. Monica wants to provide for her children and transfer some of the income potential of her new business to them.

MONICA WAGNER

Monica is a 48-year old, divorced, physical therapist with three children; Susan, Dave and Joseph ages 12, 15 and 17, respectively. She has \$400,000 in assets (\$100,000 equity in her home, \$100,000 in a retirement plan and \$200,000 in stocks and bonds) and a \$300,000 whole life insurance policy on her life. Monica has been divorced for over 10 years, is very close to her children and wants them to begin to learn about saving and investing when they are young.

At this time Monica does not want to

Monica - a single parent, new business - \$700,000 estate including her life insurance - \$37,000 tax

transfer the life insurance to a trust for her children since she is concerned that she may need the cash value for her retirement. Monica is also concerned about asset protection and wants to ensure that her assets are protected from a future husband. She has also considered starting a new company that would sell a device she designed in her sports medicine practice. If the device sells as well as she anticipates it might, it could be mass marketed and sold in retail chain stores across the nation. If the product is successful, she would like for her children to share in the benefits, but she would like to control the management and the flow of the money to her children.

Asset Protection for Monica

We have discussed the benefits of the use of a family limited partnership for asset protection purposes.

New Business Venture

Monica can form a limited partnership with her children. Monica would be the general partner and Monica and each of her children would be the limited partners. As general partner Monica will receive a

...provides flexibility in new business ventures

management fee. For this reason she has decided to retain only $\frac{1}{4}$ of the limited partnership interests and to give the remaining limited partnership interest either to her three children in custodianship accounts or to a trust for her three children. If the business is extremely successful Monica can receive her management fee and a distribution of

$\frac{1}{4}$ of the profits. If the business is not as successful, most of the profits may be paid to Monica as her management fee.

As a Teaching Device

Monica has all of her investment assets held in another partnership and has given her children interests in the partnership. She is using the partnership as a framework for teaching her children what she has learned about the stock market and mutual funds.

Protection from Spouses

To fully protect her assets from a future spouse, Monica should sign a premarital agreement. However, by holding her

...provides a framework to teach family members about investing

assets in an entity such as a limited partnership, she is better able to avoid any commingling of assets with her future husband's assets. In addition, the assets are easily identified in making gifts and in the disposition of her property upon her death.

The family limited partnership assisted the Epsons to do the following:

- < Identify and preserve separate and community property;
- < To facilitate management of property in the event either became disabled;
- < To minimize costs to transfer real estate and oil and gas properties;

- < To avoid leaving each child with small, unmanageable interests in real estate and oil and gas properties;
- < To avoid the necessity of a probate proceeding in another state;
- < To facilitate making annual gifts of property while retaining control of property; and
- < To minimize estate taxes.

The Wights have different planning needs, but the family limited partnership assists them to meet their goals, too. They can use the family limited partnership:

- < To provide asset protection;
- < To limit the inheritance to the errant, spendthrift child;
- < To discourage a will contest;
- < To manage assets, particularly for the errant child.;
- < To make gifts to the children during their lives while maintaining control of the assets; and
- < To keep control of funds held in UGMA accounts after age 21.

Monica, a single parent of three children wants to protect her estate and provide for her children, among other goals. Monica can use the family limited partnership for the following purposes:

- < Asset protection from creditors or a new spouse;

- < To manage a new business venture which has a large income potential;
- < To make gifts of the partnership interests to her children with a trust holding the children's interests so she can transfer the assets and income potential of the new business to her children; and
- < To teach her children about investing money.

The family limited partnership provides incredible flexibility to families in managing their estates in the present and in the future. Whether you're single or married, have business assets or personal assets, have children or not, or have specific problems to address, the family limited partnership may be able to resolve some of your estate planning issues. This discussion demonstrates this flexibility and how three fictitious families have used the family limited partnership to manage and preserve their estate.