

THE FAMILY LIMITED PARTNERSHIP BUSINESS & ESTATE PLAN

Revised for 2002

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WHAT IS A FAMILY LIMITED PARTNERSHIP?

1. The term “family limited partnership” is used to identify the use of the limited partnership entity for estate planning and/or business succession planning purposes.
2. A “family limited partnership” is an ordinary business limited partnership created and governed by state law.
3. Every limited partnership is made up of one or more limited partners, and one or more general partners.



General partners are liable jointly and severally for 100% of the debts and obligations of a limited partnership, whereas, generally, limited partners' liability for partnership debts is limited to their investment in the limited partnership. In order to maximize the available features and benefits of a family limited partnership, the General Partner should be a limited liability entity (e.g. a corporation or limited liability company) controlled by the senior generation and their trusted loved ones, and it will usually own a 1% partnership interest.

Limited Partners may include the senior generation, their children, and other family members and loved ones, and any other entity or person they select, such as a church, any trusts, or educational institutions. They typically own 99% of the

4. Your family's assets of your choice are placed inside the limited partnership. Selection of these assets is a very important decision in implementing a family limited partnership.
5. The General Partner controls and manages the assets placed into the limited partnership. Control over the assets is maintained through control of the General Partner. Typically, the senior generation owns the General Partner, thus controlling the assets in the limited partnership. While the senior generation may also own substantially all the limited partnership interests initially, every year the senior generation typically gifts ownership of limited partnership percentages to the younger generation and/or other chosen beneficiaries, gradually shifting value (but not necessarily control) to the younger generation.

**THE BASIC PHILOSOPHICAL REASON WHY
A FAMILY LIMITED PARTNERSHIP IS SO BENEFICIAL**

When you own an asset, you have title to it, control over it, and the value of that asset is in your estate. It is often better not to have one or more of these characteristics. Most of the significant features and benefits of a family limited partnership are rooted in the fact that the family limited partnership **splits** these three key properties of assets.

The Main Disadvantage of Value:

The Government Taxes it Upon Death.

The Main Disadvantage of Asset Ownership:

Creditors May Seize Them.

This leaves control. Control over assets is the key.

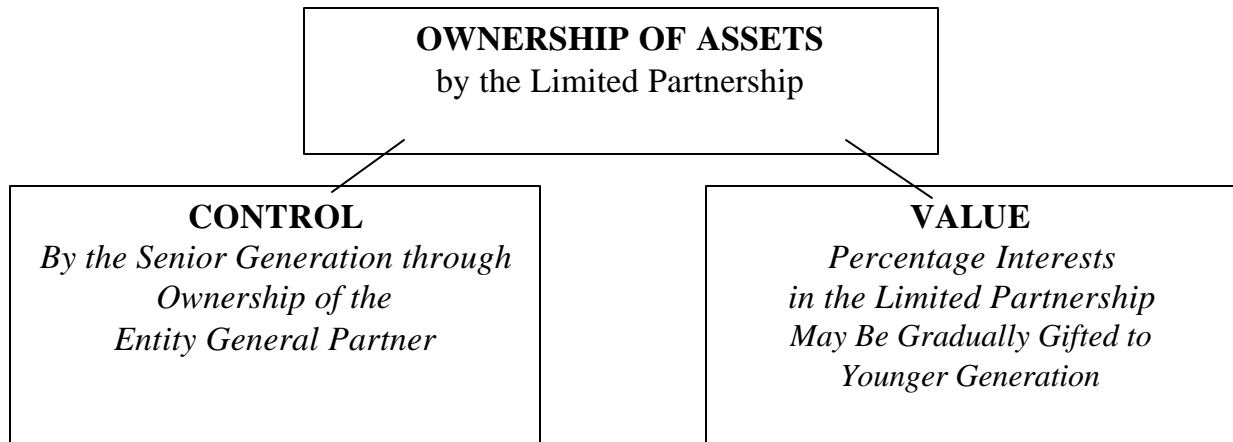
It is often more beneficial to have control over assets without also having their value or owning their title.

A family limited partnership allows the senior generation to maintain control over the assets placed into the limited partnership, without also having the negative side effects of ownership and value:

Value of the assets is now represented by the Limited Partnership interests, and not the assets directly themselves.

Ownership of assets is transferred to the Limited Partnership; and

Control over assets placed into the Limited Partnership is maintained by the senior generation through control of the Entity General Partner;



This characteristic of the family limited partnership is crucial in reducing estate taxes, protecting assets, and business succession planning, as explained in the next section of this book.

A BRIEF HISTORY OF THE FAMILY LIMITED PARTNERSHIP

The Family Limited Partnership was originally conceived to provide two benefits in the estate planning environment:

- (1) protect an individual's assets from judgment creditors in today's increasingly litigious society; and
- (2) reduce or eliminate estate taxes on ones' estate.

Prior to 1993, the Internal Revenue Service ("IRS") regularly challenged any device, including family limited partnerships, used by taxpayers to transfer the value of their estate to other family members. The IRS sought to ignore any attempted inter-family transfer, and would value a person's estate as though there had been no transfer, which would increase the estate taxes due. However, after losing almost every case they tried, in early 1993 the IRS officially changed its position, in Revenue Ruling 93-12, and thereby recognized the family limited partnership as a valid method to reduce ones' estate taxes.

In the wake of Revenue Ruling 93-12 and subsequent rulings, family limited partnerships have seen an explosion of popularity that continues to grow. Professional and public awareness of this estate planning tool is also increasing, and so more people are using the family limited partnership to realize their estate planning goals.

The IRS has not completely given up the fight against family limited partnerships. The Internal Revenue Code of 1986, as amended ("IRC"), has been specifically amended to prevent abusive uses of family limited partnerships, particularly with the enactment of Chapter 14 of the IRC, and so the drafting, implementation and operation of family limited partnerships, and any annual gifting programs, must be performed carefully and with deliberate consideration.

Nevertheless, the family limited partnership remains a superior estate planning tool which is perhaps the most flexible, dynamic plan available today. History has shown it to be a superior manner in which to build, manage, protect and pass on ones' estate. Furthermore, it is unique in that no one has to pass away in order to realize its benefits.

Before exploring many of the features and benefits of family limited partnerships, the asset protection characteristics and estate tax reduction features will first be discussed.

ASSET PROTECTION WITH THE FAMILY LIMITED PARTNERSHIP

Traditional Asset Protection Planning. Limited liability entities, such as corporations and limited partnerships, were developed many centuries ago to limit the liability of business owners to the amount they invested in the business, protecting the remainder of their personal assets from business debts. The only personal assets of the owners subject to the creditors of the business were the amounts invested in the business.

FLP Asset Protection Planning. In the family limited partnership context, this perspective is reversed. The liability being contained is one that is enforceable against an individual, not a business. An individual's assets are protected by moving ownership into a limited liability entity, in this case, a limited partnership with a limited liability entity as its general partner. The individual transfers title to particular assets to the limited partnership, and in return receives an ownership interest in the limited partnership. The individual's assets owned by the limited partnership are protected from the debts and judgment creditors of the individual because the individual does not directly own those assets anymore. There are two rules to follow.

Asset Protection Rule No. 1: Only Protect What Isn't Already Exempt. Assets fall into one of two categories: (1) Exempt Assets, and (2) Non-Exempt Assets. Non-Exempt assets may be seized by a judgment creditor to satisfy a judgment. You would lose the ownership, value and control of the assets seized by the judgment creditor. The judgment creditor would obviously pick and choose the "best" assets you have in order to collect the judgment. Exempt assets, on the other hand, cannot be seized by a judgment creditor to satisfy a judgment. It is safe to own title to Exempt Assets in your individual name.

Exempt Assets. Texas state law lists the assets that cannot be seized by any creditor to satisfy their claim. For a family, those assets include:

- Your Homestead
- Qualified Retirement Plans
- Current Wages for Personal Services (except for enforcement of child support)
- Professionally Prescribed Health Aids of a debtor or a dependent of the debtor
- Alimony, Support, or Separate Maintenance received by the debtor

Up to \$60,000 in net aggregate value of the following types of assets:

- Home Furnishings, including family heirlooms
- Provisions for Consumption
- Farming or Ranching Vehicles and Implements
- Tools, Equipment, Books, and Apparatus, including Boats and Motor Vehicles Used in a Trade or Profession
- Clothes
- Jewelry (not to exceed \$15,000)
- Two Firearms
- Athletic and Sporting Equipment, Including Bicycles
- A two wheeled, Three-wheeled, or Four-Wheeled Motor Vehicle for Each Member of a Family who Holds a Drivers License or Who Does Not Hold Drivers

License But Who Relies on Another Person to Operate the Vehicle for the Benefit of the Non-licensed Person
Two Horses, Mules or Donkeys and a Saddle, Blanket and Bridle for Each
Twelve Head of Cattle
Sixty Head of Other Types of Livestock
One Hundred Twenty Fowl
Household Pets

Non-Exempt Assets. Everything else you own is subject to being seized by a judgment creditor.

Asset Protection Rule No. 2: Protect the Value and Control Of Your Non-exempt Assets. As stated earlier in this book, a family limited partnership allows you to retain control over assets without also holding their value, which is subject to tax, and their direct ownership, which is subject to creditors. While ownership of most non-exempt assets is subject to seizure by judgment creditors, special rules apply to limited partnership interests.

The Special Rule. The exclusive remedy for a judgment creditor for a limited partnership interest, Section 7.03 of the Texas Revised Limited Partnership Act, provides that a judgment creditor may only apply to a court for a “charging order.”

A **charging order** is an order entered by a court which orders the limited partnership to pay to the judgment creditor any partnership distribution that is to be distributed to the limited partner, until the judgment is paid.¹

The effect of a charging order is:

- ∞ The judgment creditor only gets partnership distributions;
- The limited partner still exercises all other powers allowed;
- The partnership still owns all of its assets;
- The judgment creditor cannot force the partnership to distribute anything; and
- The limited partnership’s general partner maintains all control of distributions and management of partnership property; the judgment creditor cannot interfere.

¹Section 7.03 was revised effective in January of 1999 to also provide for “foreclosure” of the limited partnership interest. However, the Bar Committee comments to this section state that a foreclosure sale only conveys the right to partnership distributions permanently, as opposed to only until the judgment was paid in full. The debtor partner still remains a partner and retains the partner’s rights in the partnership other than to distributions (i.e. limited management). The notes also state that the reason the charging order and limited foreclosure rights are exclusive is to avoid the confusion and resulting interference with partnership business that might otherwise result from multiple remedies such as garnishment and attachment. Proper drafting can make this remedy to no better than a charging order.

Making a Judgment Creditor Pay Good Money After Bad. What really stings a judgment creditor about a charging order/foreclosure of a limited partnership interest, however, is the IRS's position regarding the judgment creditor. Limited partnerships file informational tax returns, and then pass through to the partners the items of income and expense, usually in proportion to their ownership. Each partner then reports the income allocated to them, respectively, on their 1040 return and they pay the tax due. If a partnership allocates income to a partner on whose interest a judgment creditor has obtained a charging order, that income is reported on the judgment creditor's 1040, not the debtor partner's 1040, and the judgment creditor must pay income tax on the allocated income.

If the partnership generates taxable income, and does not distribute any money to the partners, the judgment creditor must pay the income tax on that "phantom" income out of the judgment creditor's own pocket, a classic case of throwing good money after bad. This obviously may increase the chances of settling a dispute for the limited partner, particularly if the partner has been able to move all non-exempt assets into the family limited partnership.

You may be able to structure your estate such that the only Non-Exempt Assets you own are your interests in the Family Limited Partnership, so there are no other Non-Exempt Assets from which a judgment creditor may choose.

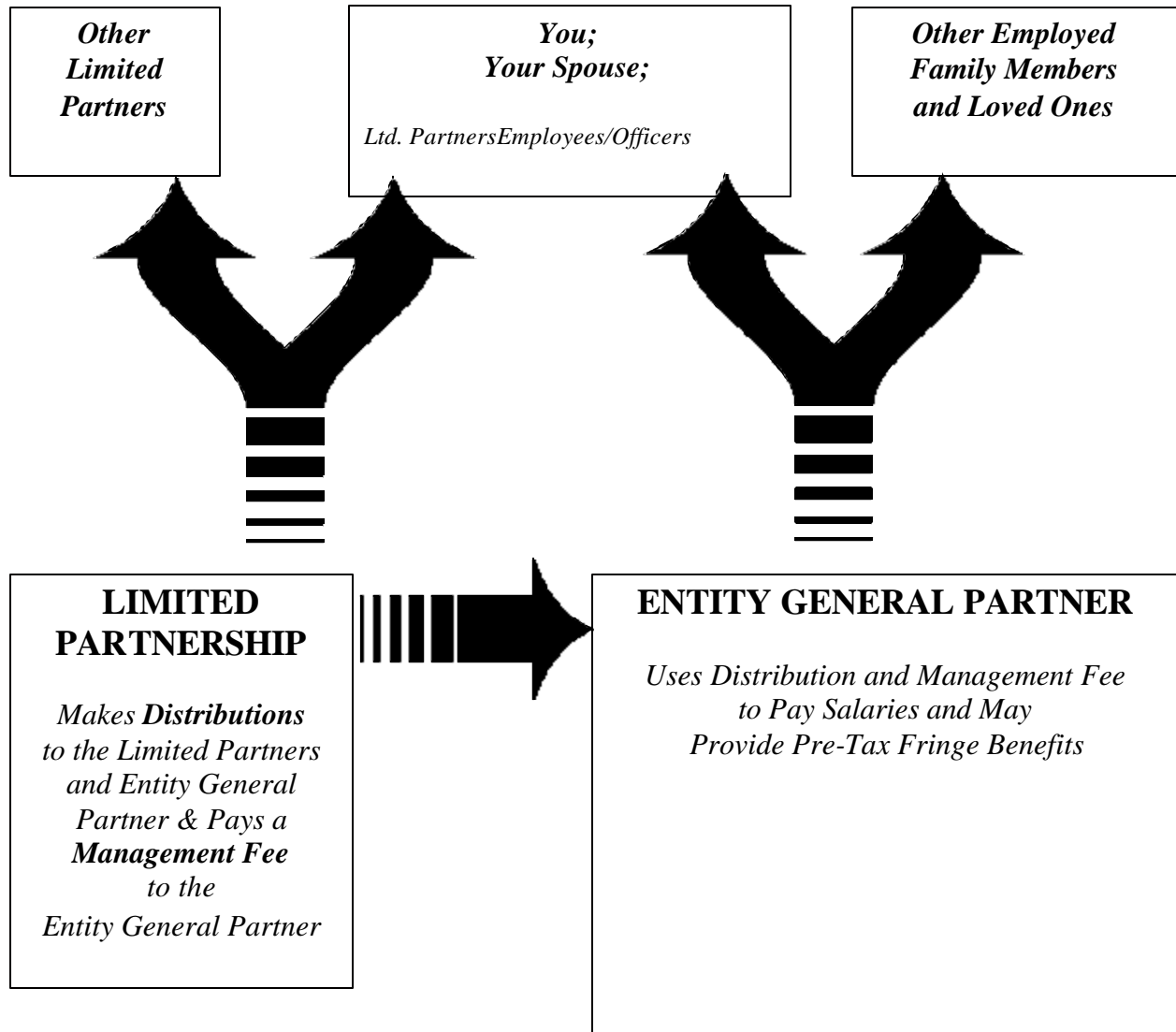
Corporation as General Partner vs. Limited Liability Company as General Partner. There is no "charging order" remedy available to protect ownership of stock in a corporation; hence, in many instances, forming a family limited partnership with a corporation as a general partner would place a non-exempt asset (the stock in the corporate general partner) in the estate(s) of the individual(s) establishing the partnership, which would be subject to the individual's creditors.

However, a "charging order" is also allowed by Texas law against membership interests in a limited liability company (Article 4.06 of the Texas Limited Liability Act). Although the statute does not make that remedy exclusive, other state statutory provisions, combined with carefully drafted organizational documents of the limited liability company general partner, may provide protection of limited liability company ownership that is practically identical to that of limited partnerships. For this reason, as a general rule, limited liability companies are the most favored entity general partners.

Getting Money Out of a Family Limited Partnership. As shown on the next page, there are two income streams created by a family limited partnership with an entity general partner. When there is no judgment creditor holding a charging order, income may flow out of the partnership in the form of distributions to the partners, and as salaries for employees and officers of the Entity General Partner.

When a judgment creditor obtains a charging order, the partnership may cease making partnership distributions to partners. Persons who are employed by the Entity General Partner may usually continue to receive compensation by the Entity General Partner while the charging order is pending.

The Two Income Streams of a Family Limited Partnership. A family limited partnership with a limited liability entity as a general partner has two income streams which afford the benefits described above: (1) partnership distributions from the Limited Partnership to the Limited Partners; and (2) salaries and other benefits from the Entity General Partner to its employees, officers, managers and directors. The following diagram shows these two income streams:



NOTE: the asset protection benefits of a family limited partnership might induce a creditor to raise an allegation that the initial transfer by the senior generation to the partnership was made to “defraud” the creditor. Texas law provides certain protections to creditors from debtors who attempt to transfer property to hinder, delay or defraud creditors. A successful creditor in this scenario “avoids” the transfer; the judgment debtor is treated as though the transfer did not occur, so that the judgment creditor may seize that asset. Persons forming a family limited partnership should retain assets outside the limited partnership sufficient to satisfy any outstanding and reasonably anticipated future debts and claims.

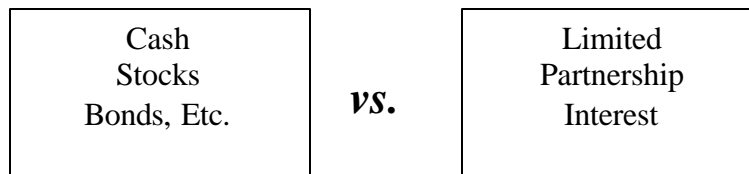
REDUCING ESTATE TAXES USING A FAMILY LIMITED PARTNERSHIP

The IRS Taxes Value. Please see this Firm's booklet "*Dying is Not a Prerequisite to Having an Estate*" in order to determine the estimated taxable value of your estate, and the estimated estate tax which would be due on an estate of that size. Estate tax rates are much higher than income tax rates and capital gains rates. Your estate is taxed at its fair market value. For estate tax purposes, "fair market value" is defined as:

the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property....is not to be determined by a forced sale price. Nor is it determined by the sale price for an item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item,, wherever appropriate.

The IRS reportedly audits every single estate tax return. The IRS wants to value your assets as high as possible in order to increase the estate tax due. In these audits the IRS is not looking for \$1,000 increments of tax as they are when they audit income tax returns; they are looking for hundreds of thousands of dollars. The fair market valuation of your estate is therefore crucial to determining the taxes due on your estate.

Transform Clean Assets into Dirty Assets. When your estate owns \$100,000 in cash, bonds, or stocks traded on a national exchange (these are known as "clean" assets), the fair market value of those assets is \$100,000. When your estate owns 50% of a limited partnership that owns \$200,000 in assets (a limited partnership interest is a "dirty" or "ugly" asset), those limited partnership interests are worth less than \$100,000.



When no public market exists for an asset, its valuation becomes more subjective, and the tools used to value unmarketable assets can result in a lower valuation for estate tax purposes, yielding lower estate taxes due.

The IRS Discounts Value for Lack of Marketability and Lack of Control. The IRS and the courts have, for many years, recognized two discounts available to persons owning an interest in a closely held business entity:

Discount for
Lack of
Marketability

Your estate would have little to no problem selling (or “marketing”) a \$100,000 CD for \$100,000, or stock on a public stock market for its face value. But there is no ready market in which a family limited partnership interest may be sold. Your estate would not be able to find a buyer to pay \$100,000 for a 50% limited partnership interest in a partnership that owned \$200,000 in assets, even though that 50% mathematically represents \$100,000 in value. To sell that 50% to a willing buyer, the estate would have to discount the sales price.

Discount for
Lack of
Control

When a buyer buys a \$100,000 CD, the buyer acquires control over the CD and can exchange it for cash, subject to any early withdrawal penalties, whenever the buyer chooses. It is therefore worth about \$200,000 to the buyer. But a willing buyer would not buy a 50% limited partnership interest in a partnership owning assets worth \$200,000, even though that 50% mathematically represents \$100,000, because that buyer would have absolutely no control over the underlying assets. That buyer may never be able to convert his ownership to \$100,000 in cash. Selling that 50% limited partnership interest to a willing buyer would require selling it at a discount of its “real” fair market value.

Using Valuation Discounts in the Family Limited Partnership. Both the discount for lack of marketability and the discount for lack of control apply to family limited partnership interests. This is where the majority of estate tax abuse has occurred; people attempt to justify outrageous discounts, even as high as 80% to 90% of the value of the assets owned by the limited partnership. A more realistic expectation is usually between 25% to 40%. This discount varies depending on the mix of clean and dirty assets owned by the family limited partnership. The more clean assets it owns, the smaller the discount will be; the more dirty, subjectively valued assets it owns, the higher the discount may be.

The Rule: Gift Tax. Federal law allows an individual to only give \$10,000 (\$20,000 if you are married and your spouse consents) to any one person or entity per calendar year, tax free. Any gift in excess of that amount is taxed in the year the gift is given. This prevents people from avoiding estate taxes by simply giving all their estate away on their deathbed.

The Problem: Can you Give Assets Away Fast Enough? An estate that has a value of \$1,000,000, which grows at the rate of 6% per year, will add \$60,000 in value in one year. In order to keep from incurring additional estate taxes on this growth, persons with an estate valued at \$1 million would have to give away \$10,000 each to six people (\$20,000 each to three people, if married and the spouse consents to and joins in making the gift) in that year. The result is that in many instances you cannot give away the value of your estate fast enough by giving away assets.

The Solution: Give More Assets Away Faster with a Family Limited Partnership. If the gift is a Limited Partnership interest, that gift is subject to the same discounts for lack of marketability and lack of control discussed above. It is therefore possible to transfer more value by gifting Limited Partnership interests than by transferring the underlying assets as the following example shows:

Situation: The Family Limited Partnership holds \$1 million in assets.

Combined Discount for Lack of Marketability and Lack of Control: 33 1/3%

Without the Discount, a 3% interest would be valued at \$30,000

With the Discount that 3% interest would be reduced to \$20,000
which is not taxable if your spouse joins in and consents to the gift

You can therefore transfer more value (in this example \$10,000 *more per year*) by gifting Limited Partnership interests instead of gifting the assets themselves. This reduces the amount of limited partnership interests (and their value) in your estate for estate tax purposes more quickly. The technical term for this is called “leveraging.”

In addition to leveraging, any appreciation of a limited partnership interest after the gift is not included in the donor’s estate for estate tax valuation purposes.

**OTHER FEATURES AND BENEFITS
OF FAMILY LIMITED PARTNERSHIPS**

1. *FLPs Are Superior Vehicles to Transfer Closely-Held Businesses to the Next Generation.*
2. *FLPs Allow the Senior Generation to Maintain Control.*
3. *FLPs May Reduce the Complexity and Cost to Probate Your Estate.*
4. *Limited Partnerships are Not Subject to Texas Franchise Tax.*
5. *FLPs May Reduce Your Income Taxes.*
6. *FLPs May Be Amended and Terminated Much Easier Than an Irrevocable Trust*
7. *FLPs Centralize the Management of Your Estate's Assets.*
8. *FLPs Are Usually Easy to Implement With Currently-Existing Estate Plans.*
9. *FLPs May Institutionalize Family Disputes Through Mandatory Arbitration.*
10. *FLP's May Deter Family Disputes With Little Merit by Using the "English Rule."*

1. FLPs ARE SUPERIOR VEHICLES TO TRANSFER CLOSELY-HELD BUSINESSES TO THE NEXT GENERATION.

Transferring a very valuable asset to a family limited partnership, like a closely held business or ranch, and then gifting limited partnership interests to children instead of the business or ranch, allows the large asset's ownership to remain intact, while providing a simplified mechanism to make gifts of these assets that might otherwise be hard to divide.

**Simpler
Transfers**

**Estate Taxes
Harm Closely
Held Businesses**

Businesses often fail within three years after the death of a business owner because of the estate taxes due at the death of the owner. In most of those instances the largest asset of the business owner's estate is the business, which is an illiquid asset preventing it from being sold, while the business does not generate the amount of cash flow necessary to pay the estate tax and sustain continued operations.

By placing the closely-held business interest in the Family Limited Partnership and then gifting the Limited Partnership interests to the succeeding generation, the closely held business is transferred to the succeeding generation with reduced or no estate tax, increasing the opportunity for the business to grow and to continue to furnish financial security for the succeeding generations.

**Educate the
Succeeding
Generation(s)**

In the Family Limited Partnership, members of the younger generation may be hired as employees of the Entity General Partner, where they may learn about the various assets owned by the family which may someday become theirs. They may also be taught how to acquire and manage wealth in accordance with the philosophy of the senior generation. If wealth is invested wisely, it can create jobs and serve altruistic purposes. This strategy may also reduce the senior generation's income taxes by transferring income to persons in a lower income tax bracket.

2. FLPs ALLOW THE SENIOR GENERATION TO MAINTAIN CONTROL

For many, giving up complete control of assets, by giving the assets themselves away, is not a viable option. However, the need remains to remove taxable fair market value from the senior generation's estate. A family limited partnership allows the senior generation to enjoy both benefits, maintaining control for security during life, by maintaining control over the Entity General Partner, while gifting away value.

**Curing the "too
much too soon"
problem**

Some families fear the effect of giving too much wealth to the next generation at any one time. Since the Family Limited Partnership allows the transfer of value without also transferring control, the older generation may gradually transfer value to the younger generation without giving up control, and then pro-actively use the continuing control to prevent the younger generation from abusing the transfers of wealth, while simultaneously teaching them how to handle and manage the wealth. Control may then be transferred as maturity and wisdom

increases.

3. *FLPs MAY REDUCE THE COMPLEXITY AND COST TO PROBATE YOUR ESTATE.*

Fewer Assets to Transfer. You may reduce the number of assets whose title must be transferred upon your death by consolidating ownership of all or most of your assets in the Limited Partnership. The titles to the assets owned by the Limited Partnership are not transferred upon your death; they remain in the limited partnership. If you were to place all of your assets into the Limited Partnership, the only assets whose title must be transferred at your death would be your Limited Partnership interest and your ownership in the Entity General Partner.

Eliminate Dual Probate. Your will must be probated in every state in which you own real property. Transferring title of real estate to the family limited partnership eliminates the need for probates in any state other than the state in which you live.

4. *LIMITED PARTNERSHIPS ARE NOT SUBJECT TO TEXAS FRANCHISE TAX.*

The Texas Franchise Tax is basically a business income tax. Corporations and limited liability companies are subject to this tax. Under current law, limited partnerships do not have to pay any Texas franchise tax.

5. *FLPs MAY REDUCE YOUR INCOME TAXES.*

Shifting Income to Lower Tax Brackets. A person in a high income tax bracket holding income producing assets can gift limited partnership interests to a person who is in a lower income tax bracket, such as junior generational family members, which may permit income to be taxed at their lower marginal rates, decreasing the overall family income tax burden.

Gifts of Limited Partnership Interests. To the extent you make gifts of Limited Partnership interests to charitable organizations, your church or your loved ones, the income distributed to those organizations and persons by the Limited Partnership is not even included in your income for tax purposes. Additionally, the value of the Limited Partnership interest that is given to qualified charitable organizations may be taken as an immediate charitable tax deduction on your current year's income taxes.

6. *FLPs MAY BE AMENDED AND TERMINATED MUCH EASIER THAN AN IRREVOCABLE TRUST.*

An irrevocable trust cannot be amended or terminated without court participation and participation by a guardian and/or attorney ad litem for any minor beneficiaries, but a Family Limited Partnership may be amended if all of the partners of the Limited Partnership agree. Also, severe tax consequences may be present on termination of an irrevocable trust, whereas a partnership is more likely to be terminated without adverse tax consequences, particularly with proper planning.

7. FLPs CENTRALIZE THE MANAGEMENT OF YOUR ESTATE'S ASSETS.

Fragmented family investments of many different types may be consolidated by placing them into the Limited Partnership. This centralization may decrease bookkeeping, frustration and operational costs. The consolidation of assets may also enable you to invest at higher rates of return.

The assets in the Family Limited Partnership will be unaffected by the death or incapacity of you or your spouse. The Entity General Partner continues to manage the assets in the Limited Partnership despite the death or disability of any of the limited partners of the Limited Partnership or of any owners of the Entity General Partner.

8. FLPs ARE USUALLY EASY TO IMPLEMENT WITH CURRENTLY-EXISTING ESTATE PLANS.

The Family Limited Partnership can integrate into existing family trusts. Credit shelter trusts, insurance trusts, educational trusts and/or revocable management trusts can all be brought together under the coordinated umbrella of the Limited Partnership.

In some cases a life insurance trust may become a limited partner of the Limited Partnership, and the partnership distributions made by the Limited Partnership may be used to pay the premium on the policy owned by the trust (unless the trust agreement specifies otherwise).

FLP's integrate with:
Wills;
Living Trusts;
Testamentary Trusts;
Irrevocable Life
Insurance Trusts;
Businesses;
Ranches

Also, a revocable living trust may also be used as a limited partner. The ownership of a Limited Partnership interest by a revocable trust avoids probate of the partnership interest held by that trust.

9. FLPs MAY INSTITUTIONALIZE FAMILY DISPUTES THROUGH MANDATORY ARBITRATION.

The Family Limited Partnership documents may require that any dispute arising in connection with the governance of either the family limited partnership or its general partner entity to be submitted to, and resolved by, binding arbitration. This may reduce the court costs and attorneys fees, facilitate constructive communication between the family members at odds, and keep the dispute private.

Private
Forum

10. FLPs MAY DETER FAMILY DISPUTES WITH LITTLE MERIT BY USING THE "ENGLISH RULE."

A family limited partnership's organizational documents may provide that when a partner brings an unsuccessful arbitration action against the management of the Limited Partnership, the unsuccessful partner must pay all costs of the arbitration. This deters frivolous actions being brought for harassment purposes against management of the Limited Partnership.

TRAPS FOR THE UNWARY

1. *Income Tax “Basis” Issues.*

“Basis” is a key concept for income tax purposes. If a person buys an asset during life for \$100, the “basis” in that asset is \$100. If that person later sells that asset for \$200, the taxpayer pays income tax, for the year in which the asset was sold, on the increased value determined as follows:

Sales Price	Less Basis	Equals Taxable Income
\$200	\$100	\$100

But if the person holds that asset until death, and the beneficiary who receives that asset then sells it for \$200, that beneficiary pays -0- tax because at death, the basis of the assets owned by the decedent is increased to the asset’s fair market value. In this instance, when the decedent dies, the basis of the asset is “stepped up” to its value on that date, which in this example is \$200. When the beneficiary then sells the asset for \$200, the taxable increased value is the difference between the basis (\$200) and the sales price (\$200), which is zero:

Sales Price	Less Basis	Equals Taxable Income
\$200	\$200	-0-

By using a family limited partnership, the assets in the family limited partnership will not receive a stepped up basis. The portion of the partnership interests owned by the decedent at death will receive a stepped up basis; however, whatever portion of the partnership interests transferred by gift during the decedent’s lifetime will not receive stepped up basis. This could result in increased future income taxes should assets in the limited partnership be sold by the donees/beneficiaries.

In weighing these divergent tax effects, many people conclude that the current potential gift and estate tax savings realized by using a family limited partnership outweigh prospective future capital gains taxes in the hands of younger generation family members. This conclusion is supported by the fact that capital gains rates are substantially less than estate tax rates. However, this issue should be evaluated as a family limited partnership is implemented.

2. *Other Income Tax Effects.*

A limited partnership is not a taxpayer; it files an informational tax return and “passes through” its various items of income and expenses to its partners. The partners then report their share of income and expenses on their individual Form 1040 returns, and pay any income tax shown on their tax return. As a result, limited partners should be aware of how the limited partnership’s financial matters will affect them in each calendar year.

3. *Distributing Enough Cash for Partners to Pay Income Taxes.*

Since a limited partnership is not a taxpayer, but rather passes its income to its partners who pay tax on it, partners are very interested in making sure the general partner distributes enough cash out of the partnership each year to at least pay any income tax attributable to partnership income.

4. *Investment Company Rules.*

Generally, no gain or loss is recognized on the transfer of property to a partnership. However, there are some very expensive exceptions to this rule. For example, if two or more persons transfer non-identical assets to a partnership, and more than 80% of the partnership's assets are readily marketable stocks or securities held for investment, the effect to the partners may be that their respective securities portfolios are thereby diversified. Under these circumstances, special "investment company" rules would apply, which may cause the partners contributing appreciated securities to the partnership to recognize gain at the time the securities are contributed. As a result, if more than 80% of the partnership's assets will be in the form of readily marketable securities, these rules should be closely reviewed.

5. *Estate Tax Inclusion Rules.*

In order to combat certain abusive uses of family limited partnerships, Congress enacted Chapter 14 of the Internal Revenue Code. This Chapter effectively determines the value of an estate as though certain transfers did not occur, and as though certain restrictions on transfers do not exist. Partnerships must be properly documented and operated to avoid application of these special rules.

6. *Valuations of Annual Gifts.*

The value of a gift is the fair market value of the gift on the date of the gift. Gift tax returns, with appraisals to support the claimed gift value, must be filed for any calendar year in which a taxpayer makes a gift. To reduce the administrative costs imposed, clients often use one appraisal of limited partnership interests as a basis for the value of a gift made at the end of one calendar year, and at the beginning of the following calendar year.

7. *Choice and Number of General Partners.*

Under Texas law, a partnership dissolves upon the death or withdrawal of its sole general partner. A "lapse in control" of a family limited partnership can cause adverse tax consequences at the time the general partner's interest lapses. In order to avoid this occurrence, a partnership may have more than one general partner (individuals or entities), or it may use an entity general partner, such as a limited liability company, corporation or trust. If the general partner is an entity, it is critical to maintain the entity general partner's existence at all times.

8. *Assets that May Not Be Contributed.*

Certain assets are required to be owned by individuals and thus should not be transferred to a family limited partnership. These include annuities, S corporation stock, and homesteads.

**DAILY OPERATION OF YOUR
FAMILY LIMITED PARTNERSHIP**

On a daily basis your Family Limited Partnership will in most cases operate as follows:

A. *ACTIONS TAKEN BY YOUR FAMILY LIMITED PARTNERSHIP*

- 1. THE LIMITED PARTNERSHIP SHOULD BE DORMANT AND HAVE NO OPERATIONS.** To the extent your circumstances require operations within the Family Limited Partnership, the operations should in most cases be placed in a separate entity owned by the Limited Partnership, because operations generate liabilities. A judgment against the Limited Partnership would expose the assets inside the Limited Partnership to the judgment and would destroy the asset protection characteristic of the Family Limited Partnership.
- 2. THE ENTITY GENERAL PARTNER SHOULD ONLY ACT AS THE MANAGING GENERAL PARTNER OF THE LIMITED PARTNERSHIP AND SHOULD HAVE NO OTHER OPERATION.** The Entity General Partner manages the assets owned by the Limited Partnership, pays salaries to its employees, provides fringe benefits to its employees, and maintains any retirement plan it sponsors. It should conduct no other activity for the same reason that the Limited Partnership should not conduct operations.

B. *GETTING ASSETS AND MONEY INTO YOUR FAMILY LIMITED PARTNERSHIP.*

You may generally transfer assets or cash into the Limited Partnership by one of the following methods:

- (1) For most items of personal property, you may execute a Bill of Sale transferring title to the asset(s) to the Limited Partnership;
- (2) For certain types of personal property, you may execute an Assignment instead of a Bill of Sale, assigning title to the asset(s) to the Limited Partnership;
- (3) For real property, you may execute either a Deed or a Deed of Trust.

C. GETTING MONEY OUT OF YOUR FLP AND INTO YOUR BANK ACCOUNT.

1. Do not use the bank accounts of either the Entity General Partner or the Limited Partnership of your Family Limited Partnership to pay for your personal bills. Use the same account you now have to pay your personal bills. Follow one of the following methods in order to transfer money from either the Entity General Partner or Limited Partnership into your personal bank account(s):
 - (a) The General Partner, as managing general partner of your Family Limited Partnership, may make a pro-rata distribution to all of its partners in accordance with the percentage interest held by each partner. Assuming a Husband and Wife each own a Forty-nine and one-half percent (49½%) interest, then for every \$100.00 distributed, Husband will receive \$49.50, Wife will receive \$49.50, and the General Partner will receive \$1.00. These amounts may be deposited into the bank accounts of the Husband, Wife and General Partner, respectively. Assuming that a Single Individual owns a Ninety-nine percent (99%) interest, then for every \$100.00 distributed, the Single Individual will receive and may deposit into their bank account \$99.00, with \$1.00 deposited into the General Partner's bank account.
 - (b) The Limited Partnership may pay a management fee to the General Partner, which should be transferred from the Limited Partnership's bank account and deposited into the bank account of the General Partner. This management fee can then be either distributed to the owners of the General Partner or paid to the officers, managers, directors or employees of the General Partner as a salary for services. To the extent any such dividends, distributions or salaries are paid to the Husband, Wife, or Single Individual, respectively, the salaries may be deposited into their personal bank account. However, you must consult your Certified Public Accountant or other qualified professional concerning the amount of taxes that must be withheld from the salaries paid.
 - (c) The Limited Partnership or Entity General Partner may make a loan to you, with a reasonable rate of interest and payout terms, in writing. When you pay the interest, you will basically be paying yourself. It is very important if you choose this option that the loan be evidenced in writing; you should consult your tax attorney or Certified Public Accountant on this matter.

In any of the above circumstances, it is strongly recommended that you seek the counsel of your accountant in order to properly record the transaction, to pay any taxes that will accrue, and, most importantly, to choose the method that results in the least tax.

D. *TAKING ACTION ON BEHALF OF THE LIMITED PARTNERSHIP.*

The General Partner is the managing general partner of the Limited Partnership. No person or entity has any authority or ability to act on behalf of your Limited Partnership except the General Partner. Whenever the Limited Partnership needs to take some action, it should sign the necessary document as follows:

[Name of Limited Partnership]

BY: [Name of General Partner]

ITS: Managing General Partner

BY: [signature of an officer of the General Partner]

[printed name of the officer signing]

ITS: [name of the office held by the officer signing]

This procedure is absolutely crucial in order to maintain the separate identity of the Limited Partnership.

E. *TAKING ACTION ON BEHALF OF THE GENERAL PARTNER.*

No person has authority to act on behalf of a General Partner except for its Board of Directors or Managers and in most instances one or more of its officers. You should consult your attorney if you have any question as to who has the necessary authority to act on behalf of the General Partner. Whenever the General Partner needs to take some action other than as the Managing General Partner of the Limited Partnership, it should sign the necessary document as follows:

[Name of General Partner]

BY: [signature of an officer of the General Partner]

[printed name of the officer signing]

ITS: [name of the office held by the officer signing]

This procedure is absolutely crucial in order to maintain the separate identity of the General Partner.

ABOUT THE AUTHOR

Mr. J. Mark McPherson is an attorney licensed by the State Bar of Texas in 1990. He began his career as an associate with the Dallas law firm of Mankoff, Hill, Held & Goldberg upon graduation from law school that same year. In March of 1995, he opened his own private practice in Plano, Texas, moving it to Dallas in 2001.

Mr. McPherson earned his law degree from Washington & Lee University in Virginia, where he won numerous Moot Court awards, including both Best Brief and Best Oralist in the John W. Davis Moot Court Competition for second and third year students. Mr. McPherson received his undergraduate degree from Belmont University in Nashville, Tennessee, where he graduated *cum laude*.

Mr. McPherson is admitted to practice before the Supreme Court of the State of Texas and all other Texas state, county and local courts, the United States District Court for the Northern District of Texas, the United States District Court for the Southern District of Texas, the United States District Court for the Eastern District of Texas, and the United States District Court for the Western District of Texas.

“My goal is to educate my clients and potential clients about the many estate planning ideas and issues, as opposed to promoting particular “one size fits all” solutions, so that they can make informed decisions for the benefit of themselves and their loved ones.”

–J. Mark McPherson

Mr. McPherson is or has been a member of the following professional and community organizations:

- ✠ American Bar Association
- ✠ Texas Bar Association
- ✠ Dallas Bar Association
- ✠ Attorneys for Family-Held Enterprises
- ✠ The Estate Planning Council of Dallas
- ✠ The Estate Planning Council of North Texas

Disclaimer Pursuant to Texas State Bar Rules:

J. Mark McPherson is Not Certified by the Texas Board of Legal Specialization in any area of law.