

## **Family Limited Partnerships and Limited Liability Companies: How to Coordinate Income Tax Issues with Estate and Gift Tax Planning**

By Steven B. Gorin<sup>1</sup>

Limited partnerships and limited liability companies can be useful vehicles to control family wealth. They are useful to centralize management and try to protect family members from outsiders, including creditors and possible future ex-spouses. They have played a role in planning to avoid transfer taxes.

Notwithstanding their usefulness, all good things must come to an end. Family members might not want to be partners their whole lives. They may develop personality conflicts or different investment objectives. We need to be just as ready to plan for their unwinding as we are to get these partnerships<sup>2</sup> formed.

How do (or should) income tax considerations affect how we structure partnerships for families? This issue was explored at some recent joint RPPT/Tax CLE presentations. A summary of a program focusing on family limited partnerships is at <http://www.abanet.org/rppt/committees/pt/c2/cle-flp.pdf>. A summary of a program focusing on limited liability companies is at <http://www.abanet.org/rppt/committees/pt/c2/Fall2003-LLCteaser.pdf>. Also, a summary of a program focusing on transferring flow-through entities in leveraged transactions (but not on their income tax aspects) is found at <http://www.abanet.org/rppt/committees/pt/c2/FridaySpotlights.pdf>. Materials for all three programs can be found at [RPPT PT \(C-2\) Estate Planning & Administration for Business Owners](#).

If you did not attend those CLEs and would like some highlights, read on. The materials referenced above are the basis for most of the comments below.

When forming partnerships, take care to avoid gain on formation. For example, suppose each partner contributes stock (whether closely-owned or publicly traded). If a partner contributes stock that does not constitute a diversified portfolio, then there is a good chance that, absent planning, that partner will be taxed on the contributed property. This concern applies notwithstanding the fact that the formation of partnerships is generally not a taxable event.

Likewise, although using property other than cash to liquidate a partner's interest generally is not taxable, some traps await the unwary (and sometimes even the wary!)

If a partner's interest in a partnership is liquidated within seven years after that partner contributed property, that partner may be taxed on liquidation. If property a partner contributed is distributed to another partner within seven years after the first partner contributed property, the

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<sup>2</sup> This article uses "partnership" interchangeably with limited partnerships and limited liability companies. For tax purposes, both entities are generally considered partnerships.

contributing partner may be taxed on the transfer. Finally, if a partner receives marketable securities, they are treated as cash and taxable unless certain exceptions apply.

This last rule about marketable securities applies whether or not the distribution is within seven years. Certain exceptions might apply, such as making pro rata distributions of that partner's share of every single marketable security in the partnership. Another exception is one that can be planned when you form the partnership. If the partnership is an "investment partnership" from inception, then pro rata distributions might not be required to avoid gain. An investment partnership is one in which, from inception, substantially all of the partnership's assets consisted of stock (whether or not marketable), cash, bonds, etc. Owning an interest in a trade or business, directly or indirectly, might preclude investment partnership treatment. Owning more than a small amount of real estate would also preclude this favorable treatment. Although some practitioners advocate having a mixture of types of assets to try to maximize valuation discounts, the actual additional discounts allowed are questionable, and the loss of investment partnership status might be too high a price to pay for any such additional discount.

Another red flag is debt, especially debt-financed losses. If a partner deducts losses, and the partner was able to deduct those losses only because the partnership's debt was attributed to him, then a transfer of the partnership interest (even a simple gift to children) might trigger income tax.

However, transferring the partnership interest to an irrevocable grantor trust should alleviate the above issues to a large degree. That's because a transfer to such a trust is ignored for income tax purposes.

Finally, consider the interplay between saving estate tax and basis adjustments due to death. Valuation discounts reduce any basis step-up. They might actually produce a basis decrease, if the contributed assets already had a high basis before the partnership was formed. You really need to crunch the numbers before a partnership files a section 754 election.

You also should preserve the family's right to amend the partnership income tax returns, and the partners' personal income tax returns, in the event of an estate tax audit. The estate tax audit could result in increased tax basis, which might then increase the basis of the partnership's underlying assets. In the case of real estate, this could generate additional depreciation deductions. In the case of marketable securities, this could reduce gain on sale due to the turnover that often occurs in portfolios.

Please check out the articles that are linked above for a better discussion of these (and other) issues. Also, you might find perusing the Probate and Trust Division Group C web site, [ABA RPPT - Probate and Trust Group C Committees](#), to be helpful to your practice.