

NONTAX BENEFITS OF LIMITED PARTNERSHIPS

The following discussion is general in nature and is not intended to specifically address the results in any client situation. Factors such as variations in state law, contractual relationships, and the nature and characteristics of assets can change the application of these generalized comments. These comments are intended only to provide a basis for further discussion.

A. Management of the Family Assets.

1. Transferring assets to an entity, such as a limited partnership, allows senior family members to retain control of the assets.
 - a. If assets are transferred directly to the younger family member rather than to an entity, the younger family member will have all the incidents of ownership with respect to the assets.
 - (1) Creditors of the donee will have direct access to the asset.
 - (2) The donee's spouse may have rights in the asset in the event of a divorce or upon the donee's death, unless the asset has been kept separate (depending upon state domestic relations law).
 - (3) If the donee dies prematurely, the asset may pass to someone rather than the person whom the donor would choose as the successor in interest.
 - (4) The donee has the ability to immediately sell the asset, unless some restriction is placed on its disposition, such as a right of first refusal. Implementing such a restriction may be cumbersome with respect to an asset other than an interest in a closely-held business, such as a partnership interest.
 - b. Senior family members can retain control by being the only general partners of a limited partnership or by control of a general partner (if the general partner is a corporation or limited liability company (LLC)).
 - c. Although a trustee has control over assets held in trust, the donor cannot serve as the trustee with discretionary authority over the distribution of income and principal without losing the desired tax benefits. This makes the use of a trust less desirable and less flexible than a limited partnership.
2. Using a limited partnership allows senior family members to restrict the right of other owners to transfer their interests, either voluntarily or involuntarily, to nonfamily members.

- a. Family members may be given a right of first refusal to purchase any interest that another family member attempts to transfer.
 - b. A donee can retain the partnership interest as separate property, thereby excluding the interest from inclusion in marital property in the event of a divorce or in the augmented estate in the event of death.
3. A limited partnership or LLC is more flexible than either a corporation or an irrevocable trust.
- a. To change certain provisions in connection with a corporation, certain formalities may be required.
 - (1) If the family decides to undo the entity, a dissolution and liquidation of the corporation usually will result in at least one level of tax and perhaps two levels of tax on any gain recognized by the corporation and the shareholders as a result of the liquidation.
 - b. Depending upon provisions of state law and the partnership agreement, a limited partnership agreement or an operating agreement of an LLC may be changed at any time by a simple majority of the partners in interest or members in interest, and the entity usually can be dissolved and liquidated without any tax consequences.
 - c. By definition an irrevocable trust cannot be amended, although there are ways of providing flexibility through the use of powers of appointment.

B. Reduced Expenses.

1. Using an entity to hold family assets reduces management expense as well as administration expenses in the event of death of a partner and provides for a more coherent investment policy.
 - a. With a larger amount involved, the cost for investment management or advice will be a smaller percentage of the value of the investments.
 - b. In addition, a larger amount enables the family to achieve a greater degree of diversification.
2. Ownership of real property by a limited partnership can avoid ancillary estate administration for real property located out of the state of the transferor's residence.
3. By using an entity, undivided interests in real property can be given away more easily than if the undivided interests are given directly to the donees.

- a. In the case of a limited partnership , the gifts of partnership interests can be accomplished through a simple transfer or assignment document, which will not require recording of deeds at the courthouse when real property is involved.
- b. Although shares of stock in a corporation are also easy to transfer, the corporation does not have the income tax benefits associated with a limited partnership.

C. Protection from Creditors.

- 1. Holding an active business or real property which might give rise to liability by reason of the operation of the business (such as potential exposure to environmental liability) in a limited partnership, may protect the owners of the entity from creditors of the business or real property and others who are injured because of the operation of the business.
 - a. In a corporation, all the shareholders have such protection.
 - b. All the members of an LLC are also insulated from entity liabilities.
 - c. Only the limited partners in a limited partnership are insulated from liability, although the general partner can be a corporation or LLC.
 - (1) However, using a corporation or LLC as a general partner presents the risk that the partnership will be treated as a corporation for federal income tax purposes and adds the expense and complication of an additional entity.
 - (2) In addition, a limited partner may become personally liable for the partnership's liabilities if he or she participates in the management of the partnership, or personally guarantees a debt.
 - d. A limited partner, member of an LLC, or shareholder will be personally liable for his or her own negligence or for debts personally guaranteed, and may be liable as an "owner" or "operator" under federal environmental law.
- 2. Assets that are transferred to an entity may not be subject to the creditors of the transferor.
 - a. In most states, a judgment creditor of a partner in a partnership is only entitled to a charging order, which treats the creditor as an assignee.

- (1) As an assignee, the creditor has the right to receive distributions to which the partner or member would have been entitled, but does not have a right to manage the business or to cause the liquidation of the entity, nor to require the distribution of income if it can be retained for valid purposes.
- b. In some cases, a creditor, having obtained a charging order, may be able to sell the debtor's interest or cause the liquidation of the entity.
- c. A creditor who has foreclosed on the partnership or membership interest would be taxed on his or her distributive share of the entity's income even though some or all of the income is retained by the partnership for valid business purposes.
- d. A transfer of assets to an entity at a time when the transferor is insolvent, or is aware of pending claims which might cause insolvency, may be treated as a fraudulent conveyance.

D. Investment Policies.

1. Using a limited partnership to hold family assets helps to educate younger family members about the investment philosophy of the senior family members and protects the assets from unwise decisions on the part of the younger family members.
2. While the prudent investor (person) rule generally will apply to a trustee of an irrevocable trust, the business judgment rule, which imposes a lower standard than the prudent investor rule, will apply to decisions made by general partners, managing members, and directors of a corporation. This lower standard will give comfort to the senior family members that the younger family members will not use 20-20 hindsight to challenge the investment decisions made by the senior family members.
3. In a state that has not replaced the prudent person rule with the prudent investor rule, using a limited partnership rather than a trust will enable the general partners or managing members to use modern portfolio theory, approved under the prudent investor rule, when making investments. This will avoid the requirement that may apply in the case of a trust to produce either current income for the income beneficiaries or growth for the remainder beneficiaries, and will allow investments with a view to total return, including current yield and growth in value.
4. If there is a disagreement among the family members, a limited partnership agreement or the operating agreement of an LLC can provide for binding arbitration to avoid lengthy and costly litigation and the attendant publicity.
5. The partnership agreement or operating agreement can require that any partner or member bringing an action against the entity or other partners or members will be required to pay all costs of arbitration if the party is unsuccessful.

6. It is important to note that the managers of a business, whether in the form of a partnership, LLC or corporation, have a fiduciary responsibility to make investment decisions in the vest interest of all owners, and not just the managing owner.