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A GUIDE TO CURRENT PRACTICE

Family Limited Partnerships in Financial and Estate Planning

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INTRODUCTION

This article consists of a substantive and analytic discussion of the uses of the family limited partnership in financial and estate planning. Following this discussion is an appendix containing sample provisions for a family limited partnership agreement.

Partnerships, and in particular, limited partnerships, have long been the entity of choice for many small or medium-sized closely held businesses. This is due to a number of factors, including: (1) ease of formation, (2) the pass-through nature of partnerships for income tax purposes, (3) the limited liability afforded limited partners, (4) flexibility in establishing procedures for management and control, and (5) flexibility in structuring the economic and tax consequences to the partners.

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Recently, estate planning practitioners have recognized the limited partnership as a flexible and extremely useful entity form in which to conduct a family business or manage family investments, and one that provides significant tax and nontax benefits. They have begun to use limited partnerships in conjunction with (and sometimes, in place of) the estate planners' staple, the trust. Many of the planning techniques described in this article using family limited partnerships may be achieved through the use of other entities, such as S corporations and limited liability companies, and, to a lesser extent, regular C corporations and general partnerships. Because of the popularity and flexibility of limited partnerships, however, the focus of this article is on the limited partnership form of conducting a family business or managing family investments. This article will discuss how to form a family partnership in which the partners are recognized as partners for tax purposes under the family partnership rules, and the varied uses for family limited partnerships.

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BACKGROUND—THE TAX ISSUES

Because of the generally favorable income tax characteristics of partnerships, the Internal Revenue Service, for some time, has challenged partnership status for tax purposes, imposing an entity level tax on partnerships that, in the Service's view, too closely resemble corporations. See *Phillip G. Larson* (1976) 66 TC 159, acq 1979–1 Cum Bull 1. Regulation §301.7701–2(a)(1) identifies four corporate characteristics: (1) continuity of life, (2) centralization of management, (3) limited liability, and (4) free transferability of interests. For tax purposes, the Service treats partnerships that have a preponderance of these four corporate characteristics as associations taxable as corporations.

Not only has the Service attacked the characterization for tax purposes of the partnership entity, but it has also challenged the tax treatment of partners within the partnership. The Service perceived abuses when partnership tax rules were applied to certain types of partners, even though other partners in the same partnership were recognized as partners for tax purposes. These perceived abuses occurred most often in partnerships among family members, where income (and associated tax liability) could be divided among family members through the partnership. Internal Revenue Code §704(e), and the regulations thereunder, commonly known as the "family partnership rules" address the issue of recognition of partner status for tax purposes. Section 704(e)(1) provides a form of "safe harbor" for recognition of partner status for federal income tax purposes, in a family partnership context.

USES FOR FAMILY LIMITED PARTNERSHIPS IN FINANCIAL AND ESTATE PLANNING

Among the potential benefits and uses of a family limited partnership are: (1) the shifting of income among family members from a higher-bracket taxpayer to a lower-bracket taxpayer, (2) facilitating the gifting of an interest in a large asset while allowing the donor to retain substantial control of the asset, (3) leveraging the $10,000 annual gift tax exclusion (IRC §2503(b)) and the $600,000 equivalent unified estate and gift tax credit (IRC §2010(a)) through valuation discounts for transfer tax purposes, and (4) asset protection.

Planning for the Shifting of Income Between Family Members

If properly structured and operated, a family limited partnership may be used to shift income from a higher-tax-bracket family member to a lower-tax-bracket family member. For tax years beginning after 1992, there are five tax brackets, ranging from 15 percent to 39.6 percent. IRC §1. An unmarried individual (other than a surviving spouse or head of household) is taxed at the 15-percent rate up to $22,100. A married individual filing a joint return reaches the 36-percent marginal bracket at an income level of $140,000, and is taxed at the maximum rate of 39.6 percent for income over $250,000. Significant tax savings can be achieved by shifting the tax incidence of income from parents, in high income tax brackets, to children, in low income tax brackets.

EXAMPLE: Mr. and Mrs. Client are highly compensated individuals, with taxable income exceeding $250,000 annually, taxed currently at the highest marginal tax rate of 39.6 percent. They have three children, all adults, each attending college. Mr. and Mrs. Client supply $20,000 annually to assist each child in attending college. To fund a net $20,000 per child, Mr. and Mrs. Client must earn, pre-tax, $33,112 per child, or a total of $99,336. If, however, Mr. and Mrs. Client were to transfer to a family limited partnership an income-producing asset generating $100,000 in income annually, and gift a 25-percent limited partner's interest to each of their three children, retaining a 25-percent interest as a general partner, each child would be taxed on $25,000, their prorata share of partnership income. At a 15-percent tax bracket, the federal income tax on $25,000 would be $3750, leaving income net of federal tax of $21,250 per child. Further, Mr. and Mrs. Client

will themselves retain income of $25,000. The total annual tax savings to Mr. and Mrs. Client is $18,450 (the difference between tax at a 39.6-percent marginal rate and tax at a 15-percent marginal rate on $75,000).

CAVEAT: There are gift tax consequences and possible real property tax consequences if the transferred asset is real estate. See discussion in Advantage of Gifting Income-Producing Asset, and Disadvantage When Donor Retains Control Over Asset "Transferred" Outright, on p 188.

Although an outright transfer of an income-producing asset will also effect a shift of the income subsequently produced by that asset (as well as the tax incidence of that income) to the transferee, an outright gift requires the transferor to relinquish control of the asset transferred. Because a partnership is not a tax-paying entity, the transferor, through the use of the limited partnership, may achieve the dual goals of shifting income to a family member while retaining control of the assets transferred, by retaining control of the partnership. See discussion under Gifting Partnership Interests While Retaining Control, p 188.

Limitations on Shifting Income

Requirement of "Substantial Economic Effect." Items of partnership income, gain, loss, deduction, or credit, although determined and reported at the partnership level, are passed through the partnership to the partners. Although a partnership acts as a conduit for tax items to the partners, it is not entirely "transparent." Partnership tax items may be allocated among partners by the partnership agreement. IRC §704(a). If the partnership agreement does not allocate these items, they are allocated in accordance with each partner's interest in the partnership. IRC §704(b)(1). For an allocation made in a partnership agreement to be effective, it must have "substantial economic effect." IRC §704(b)(2); Reg §1.704–1(b)(2). If the allocation provided for in the partnership agreement does not have substantial economic effect, it will be ignored for tax purposes, and the item(s) will be allocated in accordance with the partner's interest in the partnership. (A discussion of whether an allocation has "substantial economic effect" is beyond the scope of this article.) These normal allocation rules do not apply in certain circumstances in which the family partnership rules (discussed below) apply.

Doctrine Against Assignment of Income. As a general rule, a taxpayer cannot avoid liability for income taxes on income earned by assigning the right to receive that income. IRC §61. The tax on income resulting from the performance of services will be taxed to the person who performed the services. *Lucas v Earl* (1930) 281 US 111, 74 L Ed 2d 731, 50 S Ct 241. Likewise, income produced by capital will be taxed to the owner of the capital. *Helvering v Horst* (1940) 311 US 112, 85 L Ed 2d 75, 61 S Ct 144. If the ownership of capital is transferred, however, the tax on the income generated after the transfer will be imposed on the new owner. *Blair v Commissioner* (1937) 300 US 5, 81 L Ed 2d 465, 57 S Ct 330.

Partnerships, especially those among family members, have traditionally been closely scrutinized by the Service. Unless certain criteria are met, allowing the allocation of partnership income among the partners (although in accordance with principles of partnership taxation) may effect a shifting of tax liability among the partners in violation of the doctrine against assignment of income. Income allocated to a partner (for tax purposes) must be generated by services performed by that partner, or result from partnership capital. To the extent generated by capital, it must be allocated in accordance with that partner's true interest in the capital. Often, in family partnerships, a partner's interest in the partnership is acquired by a gift from a family member. If the transferor retains too many rights over the use and enjoyment of the property, the transferor, not the transferee, will be deemed the real owner of the partnership capital for tax purposes. *Helvering v Clifford* (1940) 309 US 331, 84 L Ed 2d 788, 60 S Ct 554.

Until the landmark United States Supreme Court case of *Culbertson v U.S.* (1949) 337 US 733, 93 L Ed 2d 1659, 69 S Ct 1210, courts were supporting the Service's position that a partner would not be recognized as a partner for tax purposes unless he or she contributed "original capital" to the partnership, or performed "vital services" on behalf of the partnership. *Commissioner v Tower* (1946) 327 US 280, 90 L Ed 2d 670, 66 S Ct 532; see also *Floyd v Akers* (1946) 6 TC 693, and *John Lang* (1946) 7 TC 6. *Culbertson* moved away from the strict requirement of "original capital" or "vital services" and stated that the test for recognizing a partner as a partner for tax purposes was whether, on "consideration of all the facts it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits." 337 US at 745, 93 L Ed 2d at 1666. *Culbertson* still required that a partner must either contribute capital or services, and if contributing capital, that the partner be the "true owner" of the capital. The *Culbertson* test remains a subjective test of intent, but one that is difficult to satisfy in connection with a non-service partner receiving his or her interest in the partnership by gift.

The "Kiddie Tax." The ability to save taxes by shifting income to children under age 14 was significantly limited by the Tax Reform Act of 1986, which added a "kiddie tax," taxing all unearned income in excess of $1000 received by a child who has not reached the age of 14 years as of the end of the taxable year at such child's parents' top marginal rate, calculated after adding the child's taxable unearned income to the taxable income of the parents. IRC §1(g).

The Family Partnership Rules

Application of General Income Allocation Rules. Although it is true that most limited partnerships subject to the family partnership rules will be partnerships of two or more family members, a family relationship among partners is not necessary for the family partnership rules to apply. The family partnership allocation rules contained in IRC §704(e)(2) apply to any partner who received his or her partnership interest by gift or purchase from a family member. The original "family partnership rules" in the 1939 Code were an attempt to provide more certainty to the tax treatment of a partner receiving his or her interest in the partnership either by gift or purchase from a family member. The family partnership rules are presently contained in IRC §704(e) and Reg §1.704–1(e). The purpose of the family partnership rules is to reconcile the principles of partnership taxation (IRC §§701–761) with the prohibition against the assignment of income, to achieve the result that "income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital." Reg §1.704–1(e)(1)(i).

The family partnership rules set forth a number of factors that will be considered by the Service in determining whether a partner will be recognized as such for tax purposes (*e.g.*, whether the partnership allocations of income will be respected). Although IRC §704(e) purports to deal with partnership interests acquired by either purchase or gift, the thrust of the regulations is to establish when a donee-partner will be treated as a partner for tax purposes. A partner who purchases his or her interest in the partnership from a family member will be treated as though he or she acquired that interest by gift. IRC §704(e)(3). "Family member" means spouse, ancestors, lineal descendants, and any trusts for the primary benefit of such persons.

The family partnership rules apply only to partnerships in which "capital is a material income producing factor." IRC §704(e)(1). Under the regulations, "[c]apital is a material income producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership." Reg §1.704–1(e)(1)(iv). Partnerships that are primarily personal service partnerships, deriving the bulk of their income from personal services of partners or employees, are generally excluded from coverage under the family partnership rules. But see *Fred J. Sperapani* (1964) 42 TC 308. A donee-partner in a partnership in which capital is not a material income-producing factor is not automatically disregarded for tax purposes, but must meet the more difficult (and more subjective) test of *Culbertson*.

Under the family partnership rules, an income allocation to a donee-partner in a partnership in which capital is a material income-producing factor will be respected *except* to the extent that the income allocation is (1) determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and (2) proportionately greater to the donee than the donor, based on their respective interests in the capital of the partnership. IRC §704(e)(2). If partnership income is generated both from capital and services, the partner performing the services must be adequately compensated by the partnership for the services rendered. The service partner should receive compensation equal to what the partnership would have to pay a nonpartner third party for comparable services. See §3.1 of the Sample Provisions for a Family Limited Partnership Agreement in the appendix following this article.

For the most part, the criteria set forth in IRC §704(e)(2) for income tax recognition of a donee-partner is fairly straightforward. The more difficult issue, addressed in the regulations, is whether the donee received his or her interest in a "bona fide transaction," and whether the donee is the "real owner" of the partnership interest. Reg §1.704–1(e)(1)(iii). This is a facts-and-circumstances determination, considering the control retained by the donor and the rights transferred to and exercisable by the donee.

The "Real Owner" Test. The transfer of a partnership interest between family members is inherently suspect. The family partnership regulations provide that transactions between family members should be "closely scrutinized," not only at the time of the transfer, but before and after the transfer. Reg §1.704–1(e)(1)(iii). If the transferor has retained too many of the "incidents of ownership" of the interest transferred, the transfer will not be recognized and, at least for tax purposes, the transferor will be treated as the owner of the transferred interest. The regulations focus on whether the donee-partner will be deemed the "real owner" of a capital interest in a partnership. A "capital interest" is defined in the regulations as "an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his

withdrawal from the partnership or upon liquidation of the partnership." Reg §1.704–1(e)(1)(v). The regulations identify a number of factors as being of "particular significance" in determining whether the transferor should continue to be treated as the owner for tax purposes. These proscribed "retained controls" are listed in Reg §1.704–1(e)(2)(ii)(a)–(d), and are:

- Control over distributions of income;
- Limitations on the right of the donee-partner to sell or liquidate his or her interest without financial detriment;
- Retention of control over assets essential to the business; and
- Retention of management power in excess of powers normally present in business relationships.

The list of retained controls is not exclusive, nor is the existence of any single control necessarily fatal to the tax characterization of a partner. Nevertheless, these retained controls should be avoided, wherever possible, when recognition of the donee-partner for tax purposes is a significant motivation to the transferor in making the transfer.

The right of a donee-partner to dispose of his or her limited partnership interest without "financial detriment" does not mean that no restrictions may be placed on disposition of the interest. Reasonable restrictions on transfer that do not require a limited partner to dispose of his or her interest at less than fair market value should not jeopardize the tax status of the limited partner. For example, a right of first refusal, even if granted to the donor, is not the type of restriction that would cause a donee-partner to suffer financial detriment on disposition of his or her partnership interest. See *Joseph Middlebrook, Jr.* (1949) 13 TC 385. Nevertheless, a conservative approach would suggest granting the right of first refusal to all partners, or all partners of a class (*i.e.*, first to all general partners, then to all limited partners), rather than singling out the donor as the sole recipient of this right. If the right of first refusal allows the donor to acquire the partnership interest for less than its fair market value, such right would constitute a retained control by the donor-partner, jeopardizing the characterization of the donee-partner for tax purposes. See *Ginsburg v Commissioner* (6th Cir 1974) 502 F2d 965.

The regulations also list a number of positive factors that tend to support the characterization of a donee-partner as the "real owner" of a partnership interest. These factors are:

- The donee-partner's active participation in the management of the partnership (Reg §1.704–1(e)(2)(iv));
- Actual distribution of partnership income to the donee-partner (Reg §1.704–1(e)(2)(v)); and
- Holding out the donee-partner to the public as a partner in the conduct of the business, as reflected in compliance with local laws, control of bank accounts, and filing partnership tax returns (Reg §1.704–1(e)(2)(vi)).

The degree of control and involvement required of a donee-partner depends on whether the donee-partner is a general partner or a limited partner. To retain limited liability protection, a limited partner is prevented, by statute, from active involvement in the day-to-day operation of the partnership. See Corp C §15632. The fact that the donee-limited partner does not contribute services or otherwise participate in the management of the partnership will be considered immaterial in determining whether there has been the requisite transfer of control over the interest, provided the limited partnership is organized and conducted in accordance with applicable state law pertaining to limited partnerships and the donee-limited partner is not deprived of the rights normally afforded a limited partner in a limited partnership formed among unrelated partners, with particular emphasis on the limited partner's right to transfer or liquidate his or her interest. Reg 1.704–1(e)(2)(ix). This is often a significant factor in the decision to select the limited partnership form.

Minors, Trusts, and Limited Partners. Not only must the donee-limited partner have rights of a "real owner," the donee must be legally and practically able to exercise those rights. For example, the regulations create a presumption that a donee-partner who is a minor will not be treated as the real owner of the interest unless (1) the minor is shown to be competent to manage his or her own property and capable of meaningful participation in partnership activities (to the same extent as an adult partner), or (2) the control of the partnership interest given the minor is vested in a third party as a fiduciary for the sole benefit of the minor, and the fiduciary's conduct is subject to judicial supervision "as is required by law." Reg §1.704–1(e)(2)(viii).

A trust may qualify as a real owner of a family limited partnership interest. The focus of the inquiry is on the rights of the trustee (as a fiduciary), rather than the rights of the beneficiary under the trust instrument. The regulations provide that a trustee who is independent and unrelated to the donor, participates in the activities

of the partnership, and receives income distributions from the partnership, will be recognized as a partner for tax purposes. Reg §1.704–1(e)(2)(vii). A trustee is not considered independent if he or she is "amenable to the will of the grantor." IRC §672(c). The regulations do not prohibit a transferor from serving as trustee, but if he or she does, the transaction will be more closely scrutinized by the Service and the trustee must demonstrate that he or she is actively representing and protecting the interests of the beneficiary, consistent with the obligations imposed on a fiduciary, and not subordinating the interests of the beneficiary to the interests of the grantor. If a material reason for forming a family limited partnership is shifting income, the grantor should generally not serve as trustee. If the trust is characterized as a grantor trust, the grantor trust rules will cause trust income to be taxed to the grantor. See IRC §§671–678.

"If the donor retains too much control over the gifted asset, or retains the beneficial enjoyment of the asset, the gift will be disregarded for federal estate tax purposes."

Gifting Partnership Interests While Retaining Control

Advantages of Gifting an Income-Producing Asset

An outright gift of an income-producing asset, especially one that is expected to increase in value, is a basic estate planning technique. Aside from the potential income tax savings (discussed above), the future appreciation of the asset is shifted from the older generation transferor to the younger generation transferee, thereby avoiding estate tax on the appreciation in the estate of the transferor. Lifetime transfers for which a gift tax is actually paid (after exhaustion of the transferor's unified estate and gift tax credit) have the additional advantage that the gift tax, paid by the transferor, is removed from the transferor's taxable estate if the transferor survives the gift by three years. IRC §2035(c). Because the payment of the gift tax is not itself considered to be a taxable gift to the donee, lifetime giving can be accomplished at a substantially lower tax cost than transfers at death.

EXAMPLE: A parent wants to make a $1 million gift to a child. Compare the net tax effect of making the gift during the parent's lifetime with making the gift at the parent's death. The gift tax on $1 million (assuming no prior taxable gifts) is $345,800. After applying the unified and estate gift tax credit of $192,800, a net gift tax of $153,000 is payable by the parent. Provided the parent survives the gift by three years, the $153,000 tax paid is not added back to the parent's taxable estate on death. If the parent is at a 45-percent marginal estate tax bracket at death, the payment of the gift tax more than three years before death rather than an estate tax at death removed $153,000 from the parent's taxable estate and saved the estate an additional $68,850 in taxes. This benefit is offset, to a degree, by the loss of use of $153,000 (the gift tax paid) between the date of the gift and the parent's death.

Disadvantage When Donor Retains Control Over Asset "Transferred" Outright

Often, the impediment to a lifetime gift is the donor's reluctance to part with control over the asset. If the donor retains too much control over the asset, or retains the beneficial enjoyment of the asset, the transfer will be disregarded for federal estate tax purposes, and the value of the asset will be pulled back into the donor's estate, valued at the date of death (or the alternate valuation date, if applicable). See IRC §§2036–2038, 2041. If this occurs, the gift is essentially ignored for federal estate tax purposes, and the value of the asset, including all post-gift appreciation, is subject to federal estate tax in the donor's estate.

Disadvantage of Disguised Sale Transactions

Transactions structured as sales rather than as gifts may get caught in the same trap. If the transaction is not "a bona fide sale for an adequate and full consideration in money or money's worth," the transaction will be characterized, at least in part, as a gift, and the retention by the transferor of any of the proscribed retained interests or powers enumerated in IRC §§2036–2038 will result in the inclusion of the transferred asset in the taxable estate of the transferor. If this occurs, the asset is valued as of the date of death of the transferor (or alternate valuation date, if applicable), reduced only by the actual consideration paid. The result is that all post-transfer appreciation in the asset is taxable in the transferor's estate.

EXAMPLE: Mrs. Smith sells the family business, a motel (where she also resides), to her son Jack for $300,000, but continues to live in the motel for the balance of her lifetime. At the time of her death, the motel is worth $1 million. If the fair market value of the property at the time of the transfer was not more than the $300,000 actually paid, the property would not be in-

cluded in Mrs. Smith's estate, and the $700,000 appreciation would escape taxation in her estate. However, if the property were actually worth $350,000, because Mrs. Smith retained possession and enjoyment of the property during her lifetime (by continuing to reside there), a prohibited interest under IRC §2036, the $1 million value of the property as of the date of Mrs. Smith's death is includable in her estate, reduced only by the $300,000 purchase price. Her estate, therefore, will pay tax on an additional $700,000, consisting not only of the $50,000 "bargain sale" amount but *all* of the subsequent appreciation to the property. Although the result in the above example is inequitable, it clearly demonstrates that the parties to an intra-family sale should adequately document the sufficiency of the sale price. Any interests or controls retained by the transferor may pull the property back into the transferor's estate, if the transaction is later characterized, in whole or in part, as a gift.

Retention of Control by Donor Through Family Limited Partnership

A gift of an interest in a limited partnership holding the asset the donor wants to transfer, when the donor (or an entity controlled by the donor) is the general partner, may allow for a completed gift without requiring the donor to relinquish effective control over the asset. The donor has control through the managerial authority of a general partner over the assets and activities of the limited partnership. That control is exercised as a fiduciary, not as an owner. Although there are no cases directly on point, the Service has ruled privately that the retention of control over an asset by virtue of the donor being a general partner in a limited partnership, or a managing partner in a general partnership, will not result in the donated interest being pulled back into the donor's taxable estate for federal estate tax purposes under IRC §2036 or §2038. See IRS Letter Rulings 9131006 and 9310039. This conclusion is also supported by the analysis of the United States Supreme Court in *U.S. v Byrum* (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382, holding that a donor's retention of voting rights in connection with gifted stock did not result in the donor's right to control the beneficial enjoyment of the stock, thereby causing the value of the stock to be includable in the donor's taxable estate for federal estate tax purposes, under IRC §2036. The Court reasoned that the duty owed by a majority shareholder to a minority shareholder compelled the donor to exercise the voting rights in a manner consistent with the rights of the donee. Although this result was changed by statute with the addition of IRC §2036(b), the reasoning of the *Byrum* decision is applicable in a partnership context, especially because the fiduciary obligations of a general partner to a limited partner are broader than those of a majority shareholder to a minority shareholder. Most recently, in IRS Letter Ruling 9415007, the Service again confirmed that, under the authority of *U.S. v Byrum, supra,* a general partner's obligation to exercise his or her rights of management consistent with his or her fiduciary duty to limited partners will preclude inclusion of the transferred interest in the general partner's gross estate under IRC §2036 or §2038.

Leveraging the Annual Gift Tax Exclusion and Unified Credit Through Valuation Discounts

The Annual Gift Tax Exclusion

A donor may gift up to $10,000 in value to each donee, in any calendar year, without the transfer constituting a taxable gift, provided that the gift is of a present interest. IRC §2503(b). Gifts of limited partnership interests are well suited for taking advantage of the annual gift tax exclusion. A single asset can be fractionalized by placing it in a family limited partnership, and annually gifting interests in the partnership valued under $10,000. Once the asset is transferred to the limited partnership, ownership of the asset does not change. If the underlying asset is real property, the recording of multiple gift deeds is avoided. If the gift is intended to qualify for the annual exclusion, care must be taken to ensure that the gift of the limited partnership interest amounts to a "present interest." This can be achieved in a number of ways. If the limited partnership agreement allows a limited partner to withdraw capital, the limited partner will be deemed to receive a gift of a present interest equal to the value of the capital account created by the gift. This method, however, may have a number of drawbacks. First, the donor may not want the gift to be immediately available to the donee. This could also have an adverse impact on any asset protection benefits of the limited partnership (discussed below), possibly subjecting the gift to claims of creditors of the donee-limited partner. A further drawback to allowing a donee-limited partner immediate access to his or her capital account is that potential valuation discounts (discussed below) may be limited or eliminated by allowing a limited partner immediate access to increases in his or her capital account resulting from gifts. Short of full and unlimited access by the donee to his or her capital account, the partnership agreement may provide for a "Crummey"-type withdrawal power. A Crummey power generally occurs in a trust context. It is a limited withdrawal right granted to a trust beneficiary, generally included for the purpose of qualifying gifts to the trust for the annual $10,000 gift tax exclusion. For a gift to a trust to qualify as a "present interest," necessary for the gift tax exclusion, the

trust beneficiary must have the right to immediate use and enjoyment of the gift. If the beneficiary has the right to withdraw the gift from the trust, even though the right may be exercised only during a specified time period, and even if the right is not exercised, and lapses, the gift nevertheless qualifies as a present interest. See *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82.

In the context of a limited partnership, this would be the donee-limited partner's right to withdraw from his or her capital account for a limited period of time following the gift (*e.g.*, 30 days) an amount equal to the lesser of the value of the gift or the available annual gift tax exclusion amount. See §§2.4–2.8 of the Sample Provisions for a Family Limited Partnership Agreement in the appendix.

A third possible solution would be to allow a limited partner a "put" with respect to the gifted limited partnership interest, entitling the donee-limited partner to sell the interest back to the grantor at its fair market value (as determined for gift tax purposes).

These techniques, however, may not be necessary for a gift of capital interest in a limited partnership to qualify as a present interest, for purposes of the $10,000 annual exclusion from gift tax. The Service, in IRS Letter Ruling 9415007, held that the receipt of an interest in a limited partnership was a "present interest," for purposes of the annual exclusion under IRC §2503(b), notwithstanding that the limited partner could not demand immediate return of capital, and the general partner retained the power over profit distributions. In so holding, the Service stated that: "Each donee will receive the immediate use, possession, and enjoyment of the subject matter of the proposed gifts, including the right to sell or assign the interest (subject to the right of first refusal)."

The gift of an interest in a limited partnership is distinguished from a contribution to capital of a limited partnership, when a portion of that capital contribution is gifted to each of the remaining partners, in proportion to their interests in the partnership. If a partner's interest in the family limited partnership is determined by his or her capital account, an additional contribution to capital by one partner, if credited solely to the contributing partner's capital account, would dilute the percentage interests of the remaining partners in the partnership. A gift to the capital account of each noncontributing partner in direct proportion to each partner's interest in the partnership maintains the proportionate interest of the limited partner, and should be functionally equivalent to a gift of a limited partnership interest to compensate for a dilution. Nevertheless, it is not as apparent that, for purposes of determining whether a gift is one of a "present interest," a gift of capital is the equivalent of a gift of an additional interest in the entity. Consideration should be given to whether additional gifts, intended to qualify for the annual exclusion, may be structured by shifting capital within the partnership, rather than the more traditional methods of transferring an additional limited partnership interest, or gifting the property to be transferred directly to the recipient outside of the partnership, and having the recipient contribute the property.

"The principal characteristics of a limited partnership interest allowing a discount valuation are: (1) lack of marketability; (2) lack of control (minority discount); and (3) fractional interest."

For purposes of qualification for the annual gift exclusion, it is not enough to establish that a gift of an interest in a limited partnership can qualify as a present interest. The donee-limited partner actually must receive a present interest. If the limited partner is a trust, the trust must either be a "minor's trust," qualified under IRC §2503(c), or the beneficiary of the trust must have a right to immediate use of the gift, such as through a Crummey withdrawal power.

Leveraged Giving Through Valuation Discounts

A gift of a limited partnership interest rather than a gift of a direct interest in the underlying asset may result in the availability of a number of valuation discounts applied to the transferred interest, thereby allowing the donor to "leverage" the $10,000 annual gift tax exclusion and the $600,000 unified credit equivalent. A gift will be valued at the fair market value of the property at the time of the gift. IRC §2512(a). The regulations define fair market value as "[t]he price at which such 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." Reg §25.2512–1.

The valuation of an interest in a "business," including a business operated as a partnership, generally cannot be established with precision unless interests in the business are publicly traded. If no public market exists for the business interests, the value of an interest in the business is determined based on a number of factors. The regulations are of some (but limited) assistance in

this regard, listing a number of factors to be considered in valuation of a business interest. Regulation §25.2512–3(a) lists the factors as including: (1) a fair appraisal of the assets of the business (including goodwill); (2) the demonstrated earning capacity of the business; and (3) other factors contained in Reg §25.2512–2(f) relating to the value of corporate stock, "to the extent applicable." Revenue Ruling 59–60, 1959–1 Cum Bull 237, discusses additional factors relevant in valuing the stock of a closely held corporation. Although presented in the context of valuing corporate stock, the factors discussed should be equally relevant in valuing a closely held business conducted in partnership form.

One of the factors identified by the regulations in valuing an interest in a business is the degree of control of the business represented by the interest being valued. Reg §25.2512–2(f). In the corporate context, the focus of the analysis is on the number of shares of the block being valued compared to the total outstanding shares, whether the shares being valued are voting or nonvoting shares, and how widely the remaining shares are held. In the limited partnership context, however, control over the entity is not necessarily directly related to ownership interests, as it is with corporations. A sole general partner with a 1-percent interest in a limited partnership controls the operation of the partnership, although 99 percent of the equity of the partnership is held by the limited partners (usually subject to the limited partners' right to remove and replace the general partner). The lack-of-control element in the valuation process therefore would be applied to result in a discount attributable to what is actually a majority ownership interest in the enterprise. When a donor gives away less than his or her entire interest in the gifted asset, the value of the gift is limited to only the interest transferred. Reg §25.251–1(e). If the interest given away lacks the control element that attached to the interest before the transfer, the lack of control will reflect on the value of the transferred interest. Because in a limited partnership context the discounted value that generally applies to a "minority interest" can be applied to a "majority interest" held by a limited partner, the family limited partnership is well suited for transferring the largest interest in a family business at the lowest transfer value, and hence the smallest transfer tax cost.

In valuing an interest in a limited partnership, a number of characteristics of the interest will result in discounted valuation (compared to the prorata fair market value of the partnership's assets). The principal characteristics of a limited partnership interest allowing a discount valuation are: (1) lack of marketability; (2) lack of control (minority discount); and (3) fractional interest.

Discount for Lack of Marketability. A discount on value based on the lack of marketability of the interest recognizes that there is no public market for the interest and hence that the holder has a relatively "illiquid asset." This is especially true when the partnership interests are family held. In addition to the practical issues of locating a purchaser for an interest in a family held partnership, the partnership agreement itself may contain restrictions on transfer of partnership interests. Typical restrictions on the transfer of a limited partnership interest include (1) approval of the general partner; (2) approval of a majority of the limited partners; (3) a right of first refusal in favor of the general partner(s) and/or remaining limited partner(s); (4) obtaining an opinion of counsel that the transfer will not cause a termination of the partnership for tax purposes; (5) requiring the transferor to pay a transfer fee to the partnership; (6) requiring the transferee to meet suitability criteria; and (7) requiring the transferee to agree to be bound by the terms of an existing buy-sell agreement.

CAVEAT: Care must be exercised in drafting transfer restrictions in the limited partnership agreement when it is anticipated that any of the limited partners will be receiving their interest by gift. If the donee-partner cannot liquidate or dispose of his or her interests without suffering "financial detriment," the donee-partner may not be recognized as a partner for tax purposes. See Reg §1.704–1(e)(2)(ii)(b). Any restriction on the transferability of the partnership interest that would not normally be found in a business partnership among unrelated partners should be carefully considered before inclusion in a family limited partnership agreement.

Discount for Lack of Control. What is traditionally referred to as a "minority discount" in referring to a noncontrolling block of stock is more accurately described as a lack-of-control discount when referring to a limited partnership interest, because the interest actually may be a majority interest in the partnership. The lack of control results from limitations imposed on the limited partner by statute and by the partnership agreement, rather than by the limited partner's comparative interest in the partnership. See Corp C §15632.

For many years, the Service and the courts were at odds as to whether a "lack of control" discount was available in valuing transfers among family members. The Service's position was set forth in Rev Rul

81-253, 1981–2 Cum Bull 187, in which it held that a minority discount would not be available in valuing a gift of stock from the sole shareholder of a corporation to the shareholder's three children. Without a showing of family discord, or other factors indicating that the family would not "act as a unit," no minority discount would be allowed if, after the transfer, control (either by holding a majority interest or de facto control) remained in the family. The weight of case law, however, favored the non-aggregation rule, which holds that the interest held by family members would not be aggregated in determining whether a minority discount applies. See *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248; *Estate of Bright v U.S.* (5th Cir 1981) 658 F2d 999; *Estate of Woodbury G. Andrews* (1982) 79 TC 938. In 1993, in a reversal of its position, the Service issued Rev Rul 93–12, specifically revoking Rev Rul 81–253, and holding that when shares of a corporation are gifted to the donor's children, the factor of corporate control in the family will not be considered in valuing the transferred interest. Under these circumstances, the Service held, "a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest." Although Rev Rul 93–12 deals with corporate stock rather than an interest in a partnership, the concepts should apply equally to partnerships. Just as valuation regulations dealing with corporate stock in closely held corporations have been applied by the courts in valuing partnership interests, Rev Rul 93–12 will undoubtedly be applied by the courts in the partnership context.

Discount for Fractional Interest. Fractional interest discounts may apply when the partnership owns less than a 100-percent interest in property. A fractional interest discount contains elements of both the lack of control (minority interest) discount and the lack of marketability discount, applied directly to the partnership's assets. See *Samuel J. LeFrak,* TC Memo 1993-526. In any co-ownership, no single owner has the unfettered control over the use and disposition of the property. The limitations on the use and enjoyment of the property by a co-owner render the interest less valuable. However, when a fractional interest is held by a partnership, the partnership agreement will establish the rights of the partners regarding the property. Typically, a partner will not have the right to demand that he or she receive any particular partnership property. Because discounts for lack of control and lack of marketability are already applied to a partnership interest, the appraiser or other valuation expert must take these discounts into consideration in applying any additional discount for the fractional interest held by a partnership, to avoid double discounting for the same restriction.

"The so-called 'anti-abuse regulations' will allow the Service to ignore a partnership entity or refuse to recognize a partner as a partner for tax purposes, if it is perceived that the partnership is not conducted consistent with the 'intent of Subchapter K.' "

The Service took the position in a recent technical advice memorandum (IRS Letter Ruling 9336002) that a discount for a fractional interest should be limited to the cost of partition. In the case of a partition action, if the property cannot be physically divided among the co-owners (which is usually the case) it will be sold in a court-ordered sale. Although the cost of maintaining a partition action is certainly one element that must be considered, the delay in bringing the property to sale (often after several years from the commencement of the action), as well as the fact that the sale is a "forced sale," rarely resulting in a sale price equal to what could have been obtained under normal marketing conditions, also should be considered in valuing the fractional interest. In a limited partnership, the partners do not have the right to seek partition of partnership assets. If a fractional discount is sought for an asset in the partnership, however, it may be appropriate for the partnership to enter into an agreement with the co-owner(s) to waive the right of partition, thereby eliminating the Service's argument.

Avoiding the Special Valuation Rules of IRC §2701. Internal Revenue Code §2701, and the regulations thereunder, provide special valuation rules that cover transfers of partnership interests between family members. These valuation rules were added to the Internal Revenue Code to combat a technique commonly known as "estate freezing." When these rules apply, the general rule of valuing a gift based on the value of what the donee receives is changed. The gift is valued based on the value of the donor's entire interest in the partnership before the transfer, less the value of the interest retained by the donor. These valuation rules, contained in Reg §25.2701–3(b), generally result in a substantially higher valuation of the gifted interest,

because, under these rules, the retained interest is usually valued at zero.

These rules will apply only when the interest in the entity (partnership or corporation) is transferred to a member of the transferor's family, and when the transferor retains an "applicable retained interest" (as defined in Reg §25.2701–2(b)(1)). An "applicable retained interest" includes a "distribution right" (as defined in Reg §25.2701–2(b)(3)) in a "controlled entity" (as defined in Reg §25.2701–2(b)(5). A partnership which, immediately before transfer, is controlled by the transferor or members of the transferor's family, will constitute a "controlled entity." This is typically the situation in a family partnership context. The proscribed "distribution right," however, does not include an interest of the same class as the interest transferred. Reg §25.2701–2(b)(3)(i). Nonlapsing differences as to management and limitations on liability do not create a separate class of interest for purposes of determining the "distribution rights." Reg §25.2701–1(c)(3). Therefore, a transferor transferring a limited partnership interest, and retaining a general partnership interest, is not deemed to have retained an "applicable retained interest" within the meaning of IRC §2701, and regulations thereunder, because the interest transferred and the interest retained are considered of the same class. Under these circumstances, the special valuation rules will not apply.

Proposed Partnership Regulations. The Service has recently proposed new regulations (Prop Reg §1.701–2), purportedly to enable it to disregard the partnership entity if the partnership is formed with a principal purpose of substantially reducing the partners' aggregate income tax liability. These so-called "anti-abuse regulations" will allow the Service to ignore a partnership entity or refuse to recognize a partner as a partner for tax purposes, if it is perceived that the partnership is not conducted consistent with the "intent of Subchapter K" (the partnership provisions of the Code). These proposed regulations would allow the Service to recharacterize the tax consequences of partnership transactions based on a subjective determination of whether such transactions were consistent with the intent of Subchapter K, notwithstanding full compliance by the partnership with the letter of the law.

Although the Service has indicated that the proposed regulations would likely affect a relatively small number of large limited partnerships, the effect on tax planning involving partnerships, including family limited partnerships, remains uncertain. The proposed regulations contain an effective date for partnership transactions occurring on or after May 17, 1994.

Family Limited Partnerships and Asset Protection

A properly structured family limited partnership will afford the partners a certain degree of asset protection from creditors. This assumes, of course, that the formation of the family limited partnership does not involve a fraudulent conveyance, and is not formed with the actual intent to hinder, delay, or defraud creditors. Any such conveyance will be voidable. See 11 USC §548(a)(1); CC §§3439.04(a), 3439.07.

Limited Liability of Limited Partners

Parties often select a limited partnership form of doing business over a general partnership because the liability of the limited partners is limited. See Corp C §15632. A limited partner's exposure to the claims of partnership creditors is confined to the limited partner's contributions to the capital of the partnership, and any additional capital contribution the limited partner is obligated to make. Of course, the limited partner is shielded only from claims of creditors of the partnership, and not from claims deriving from his or her non-partnership debts.

Insulating Partnership Assets From Claims of Creditors of Partners

One remedy available to a judgment creditor of a partner is a "charging order" against the debtor's partnership interest. A charging order is a statutorily authorized court order subjecting the partner-debtor's interest in the partnership to the claim of the creditor. For limited partnerships governed by the California Revised Limited Partnership Act, Corp C §15673 provides that:

> On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the limited partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the limited partnership interest. This chapter does not deprive any partner of the benefit of any exemption laws applicable to the partner's limited partnership interest.

This provision is generally construed as providing for a court-ordered assignment to the creditor of the debtor's interest in the partnership. Usually, on the assignment of a debtor's partnership interest, the creditor-assignee will not become a substituted partner (general or limited), with all the rights of a partner (*e.g.*, voting, the right to examine partnership books and records), but will only have the debtor-partner's right to receive distributions from the partnership. If the partnership agreement is properly drafted to allow the general partner to accumulate profits for the rea-

sonable needs of the business of the partnership (and assuming that the debtor-partner is not in control of making distributions) the creditor may have to wait some time to receive any meaningful distribution from the partnership. Because an assignee can have no greater rights in the partnership than the debtor-partner, if the debtor-partner has no right to demand return of capital or force a liquidation of the partnership interest, the creditor will likewise have no such right.

Cases decided under different versions of the Revised Uniform Limited Partnership Act have reached different conclusions as to whether a charging order is the creditor's exclusive remedy. In *Crocker Nat'l Bank v Perroton* (1989) 208 CA3d 1, 255 CR 794, the California Court of Appeal held that a lower court's order compelling the sale of a debtor's partnership interest, after a charging order proved to be ineffective, did not constitute an abuse of discretion by the lower court. This case, however, was decided under the California Uniform Limited Partnership Act, not the California Revised Limited Partnership Act. Additionally, the general partner consented to this sale, which rarely happens in a family partnership situation. See also *Hellman v Anderson* (1991) 233 CA3d 840, 284 CR 830, holding that a court, pursuant to its equitable powers, may order foreclosure of a charged partnership interest if it will not "unduly interfere with the partnership business."

Cases under the Revised Uniform Limited Partnership Act (although no California cases) have held that a charging order is a creditor's "exclusive remedy" in connection with a partnership interest. See *Chrysler Credit Corp. v Peterson* (Minn App 1984) 342 NW2d 170. To add insult to injury to the creditor, it appears that a creditor who obtains a charging order will be taxed on the debtor-partner's share of partnership profits, whether or not actually distributed. See Rev Rul 77–137, 1977–1 Cum Bull 178 (treating assignee as partner for tax purposes, even though assignment violated the partnership agreement). Although creditors have argued that taxing them on income violates the doctrine against the assignment of income, because the charging order would give them an interest in the underlying capital of the partnership, the income tax consequences of profit allocations would follow the underlying ownership of the capital, and hence not violate the assignment-of-income doctrine.

Drafting a Limited Partnership Agreement for Asset Protection

If asset protection is a consideration for forming a family limited partnership, the partnership agreement should contain certain provisions that set forth the rights of the creditor acquiring an interest in the partnership by virtue of obtaining a charging order, or by levy or execution, or other similar method (referred to herein as an "involuntary assignment").

Rights of an Assignee; Substituted Partner. An assignee of an interest in a limited partnership is not usually entitled to exercise all of the rights of a partner, unless the limited partnership provides that the assignee becomes a "substituted partner," and the assignee complies with the requirements contained in the partnership agreement for becoming a substituted partner. Corp C §§15672, 15674. A family limited partnership agreement should specifically provide that an assignment of a partnership interest, whether voluntary or involuntary, (1) will not cause a dissolution of the partnership; (2) will not entitle the assignee to exercise any of the rights of a partner; and (3) will entitle the assignee to receive distributions and allocations to which the assignor was entitled, to the extent of the interest assigned. See §4.4 of the Sample Provisions for a Family Limited Partnership Agreement in the appendix. The partnership agreement should also set forth the circumstances under which an assignee can become a substituted partner (general or limited). This should require either the consent of all partners, or the consent of the general partner, which may be withheld in the general partner's sole discretion. The partnership agreement may set forth additional requirements for an assignee to become a substituted limited partner, such as executing an amendment to the partnership agreement agreeing to be bound by its terms, or the payment of a reasonable transfer fee. See §4.5 of the Sample Provisions in the appendix. If the interest assigned is a general partner's interest in the partnership, the partnership agreement should provide for conversion of the assigned interest into a limited partner's interest, and the assignor-general partner should cease to function as a general partner. If the assignor was a sole general partner, the agreement should provide for a majority of the limited partners electing a new general partner. The agreement should also provide that the assignee shall have no rights to and may not interfere with the management and operation of the partnership. See §4.6 of the Sample Provisions.

Distribution of Profits. Because an assignee will have the same rights as an assignor to receive profit distributions, it is important that the partnership agreement not allow a partner to compel distributions. Under the family partnership rules, whether a donee-partner has a right to receive income is a relevant factor in determining whether the donee-partner is the "real owner" of his or her partnership interest. A general partner may accumulate income in the partnership to

the extent reasonable and appropriate for the business needs of the partnership. Although the partnership agreement should provide that the general partner will distribute "excess cash flow," a properly drafted purpose clause, broad enough to allow the general partner to accumulate cash for future investment, will assist in this regard. See §1.3 of the Sample Provisions in the appendix.

CAVEAT: The Service considers distributions of income to donee-partners to be an extremely important factor in determining whether the donee-partner is the "real owner." Therefore, great care must be exercised in drafting provisions relating to the authority of the general partner to retain partnership profits in the partnership. See §§3.3–3.5 of the Sample Provisions.

Return of Capital. Under the California Revised Limited Partnership Act, a partner is entitled to receive distributions from the partnership before his or her withdrawal as a partner, and before dissolution and winding up of the partnership. Corp C §15661. Unless the partnership agreement provides otherwise, a limited partner may withdraw from the partnership on six months' written notice to the general partner. Corp C §15663. To prevent an assignee of a limited partner's interest from being able to liquidate his or her interest by withdrawing from the partnership, a limited partner's right to return of capital should be limited to dissolution of the partnership (which cannot be unilaterally caused by the limited partner). See §4.4 of the Sample Provisions in the appendix. Also, providing a definite termination date for the partnership will override a limited partner's withdrawal right under Corp C §15663. See §1.4 of the Sample Provisions.

FUNDING THE FAMILY LIMITED PARTNERSHIP

There are a number of considerations in funding a family limited partnership.

Nature of Assets

A family limited partnership should be funded with assets used in connection with a business (conducted by the partnership) or assets held for investment. California law defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." Corp C §15006. The Internal Revenue Code defines a partnership as an unincorporated organization (other than a trust or estate) "through or by means of which any business, financial operation, or venture is carried on." IRC §7701(a)(2). If the partnership has no business or investment purpose, it may not be recognized as a partnership, either for tax or state law purposes. Therefore, personal use assets, such as household furniture and furnishings, should not be transferred to a family limited partnership. That is not to say that an asset may not be converted from a personal use asset to a business or investment asset. For example, a family residence may be transferred to a family limited partnership, provided that the transferor (who presumably continues to reside in the residence) pays fair rental value to the partnership. Great care must be exercised, however, when the transferor will continue to use the transferred asset. If the right to continue to use or benefit from the property is deemed a retained right (rather than pursuant to a rental or lease agreement for full fair rental value) the donee may not be considered the "real owner" for income tax purposes, and under IRC §2036, the value of the asset will be pulled back into the transferor's estate for estate tax purposes. For this reason, funding a family limited partnership with assets that will be used by the general partner generally should be avoided.

Avoiding Gain on Transfer of Assets to Family Limited Partnerships

Generally, a transfer of an asset to a partnership, general or limited, in exchange for an interest in the partnership, will not result in recognition of gain. IRC §721(a). However, there are a number of exceptions to the rule.

Liabilities in Excess of Basis

A decrease in an individual partner's personal liability by reason of the assumption by the partnership of such liability is treated as a distribution of money by the partnership to the individual partner. IRC §752(b). Therefore, if a partner contributes to a partnership property subject to a liability in excess of the transferor's basis in the property, and such liability is assumed by the partnership, the decrease in the individual partner's liability over the partner's basis in the contributed property will be a taxable distribution to the partner. IRC §731(a)(1). The extent to which a partner is relieved of a liability depends, in part, on whether the liability is recourse or nonrecourse.

Disguised Sale

If a partner transfers property to a partnership and the partnership, in a related transaction, distributes money or other property to the partner, the transaction may be reclassified as a sale of the property to the partnership, triggering gain on the sale. IRC §707(a)(2)(B). The regulations create a presumption that if a partnership transfers money or other consideration to a partner within two years of the transfer of the property by such partner to the partnership, the transaction will be treated as a sale, unless the facts and circumstances establish that the transfer was not a sale.

Reg §1.707–3(c). For example, demonstrating that the distribution was made to all partners in accordance with their interests in the partnership should be sufficient to rebut the presumption.

Additionally, if the contributed property is distributed to another partner within five years of the date of original contribution, the contributing partner will recognize gain as though he or she sold the property at its fair market value as of the date of distribution. IRC §704(c).

Reappraisal of Property for Property Tax Purposes

Family limited partnerships are often funded with interests in real estate. If the property currently has a favorable assessment for property tax purposes, care must be taken to avoid triggering a reassessment. Revenue and Taxation Code §62(a) exempts from the definition of a "change in ownership" a transfer between an individual and a legal entity (including a partnership) "which results solely in a change in the method of holding title to the real property and in which proportional ownership interest of the transferors and the transferees, . . . remain the same after the transfer." For example, if a husband and wife own property as community property, they may form a limited partnership in which one of them is a general partner, and one or both of them are limited partners. If each owns a 50-percent interest in the partnership, the transfer of the property to the partnership would not trigger a reappraisal. If real property is held by a partnership, no reappraisal of the partnership will be triggered by a transfer of interests in the partnership, unless the original owners transfer, in the aggregate, more than a 50-percent interest in the entity. Rev & T C §64(d). Additionally, certain exemptions apply for transfers between a parent and child. A transfer of a principal residence, and the first $1 million of full cash value of other real property transferred between a parent and child (in either direction) will be exempt from reappraisal, with a timely filed claim for exemption. Rev & T C §63.1. A transfer of an interest in real property between individuals not qualifying for an exemption will result in a reassessment, but only of the interest transferred. To avoid a reassessment on change of ownership, if there are multiple owners of the property, the partnership may be formed first among the original owners, with their interests in the partnership identical to their interests in the real property before the transfer. The transfer to the partnership will not trigger a reappraisal, and as long as not more than 50 percent of the interests in the partnership are transferred, there will be no reappraisal. In the alternative, in a family partnership, the transfer may be directly to the transferor's children if the parent-child exemption is available. Having created joint ownership, the parties can then contribute the real estate to the partnership, taking interests in the partnership equal to their interests in the real estate, thereby avoiding reappraisal. If the transferees are not children (or stepchildren) of the transferor, so that the parent-child exemption is not available, transfers to the individuals first will at least avoid a reappraisal of the entire property, limiting the reappraisal to the interest transferred. Care must be taken, however, to avoid liens attaching to the property as a result of passing title through the intended partner.

If the property has declined in value from its current tax assessment, triggering a reappraisal by transferring the property to a partnership may be the most expeditious manner of effecting a reduction of the assessed value.

CAVEAT: When a reappraisal resulting from a change in ownership is avoided or minimized through multiple transactions (i.e., transfer from parent to child and child to partnership, transfer of additional interest in partnership from parent to child), there is a danger that the multiple transactions may be collapsed into a single transaction under the "step transaction doctrine."

In *Schuwa Inv. Corp. v County of Los Angeles* (1991) 1 CA4th 1635, 2 CR2d 783, the court set forth a three-pronged test to determine whether the step transaction doctrine should apply to multiple transactions. The first prong is whether each of the multiple transactions was taken for the sole purpose of achieving a single "end result." The second prong is whether the multiple transactions were so interdependent that one would not occur without the other two. The final prong of the test is whether there is a binding commitment, once the first step is taken, to complete the remaining transactions. In the family partnership context, as long as the initial transferee (the child) is not under any binding legal obligation to retransfer the property to the family limited partnership, the step transaction doctrine should not apply.

CONCLUSION

Family limited partnerships, if properly created, funded, and operated, can be used to achieve considerable income, estate, and gift tax benefits, and should always be considered as part of any sophisticated estate plan.

Appendix

FORM.
Sample Provisions

Sample Provisions for a Family Limited Partnership Agreement

This section sets forth sample clauses for a family limited partnership agreement. Unless otherwise noted, cross-references are to specific sections of the article that are relevant to an understanding of the particular provision.

CAVEAT: These provisions are intended as examples of provisions relevant to issues involving family limited partnerships. This is not *a complete limited partnership agreement, and many provisions that would be appropriate in a limited partnership agreement have been omitted. See Advising California Limited Partnerships, chap 5 (2d ed Cal CEB 1988), for a complete sample form for a limited partnership agreement.*

ADAMS FAMILY LIMITED PARTNERSHIP

THIS AGREEMENT OF LIMITED PARTNERSHIP (Agreement) is made and entered into this _____ day of _____, 199__, by and among John Adams and Mary Adams, Trustees, the Adams Family Trust, U/D/T, dated _____, 199__ (Adams Family Trust) as the General Partner, and the persons whose names are set forth on Exhibit A, attached hereto, as the Limited Partners.

COMMENT: A limited partnership must have one or more general partners and one or more limited partners. Corp C §15611(r). This form provides for a revocable family trust as the general partner. When a revocable trust is the sole general partner, because such a trust does not constitute a distinct legal entity, the partnership should have at least one limited partner who not a settlor of the trust. If the children are adults, they may be limited partners. If the children are minors, it is best that the limited partners' interests be held in trust for the benefit of the children. See Minors, Trusts, and Limited Partners, on p 187.

CAVEAT: If asset protection is a principal consideration of the family limited partnership, it is preferable that the transferor not be the sole general partner, nor control the sole general partner. A creditor of the general partner (under a charging order) or a trustee in the general partner's bankruptcy may gain control of income distributions, liquidate partnership assets, or cause dissolution of the partnership. A corporation (often an S corporation) may serve as a sole general partner or a co-general partner with the transferor. The stock of such a corporate general partner should not be held directly by the transferor, but may be held by a trust for the benefit of the children of the transferor, of which the transferor is the trustee. See Rights of an Assignee; Substituted Partner, p 194.

ARTICLE I

THE PARTNERSHIP

1.1. *Formation.* The parties hereto hereby agree to join together to form a Limited Partnership under the California Revised Limited Partnership Act (Act).

COMMENT: This establishes the intent of the parties to create a limited partnership.

1.2. *Partnership Name.* The name of the Partnership shall be the Adams Family Limited Partnership.

COMMENT: The partnership name may include the surname of a partner, but this is not a requirement. Avoiding use of the family name may provide an additional degree of privacy in holding title to real property (if the transferor or someone with the same surname as the transferor is not the trustee). A name other than the name appearing on the partnership's Certificate of Limited Partnership (Form LP–1) is considered a fictitious name, and the partnership should comply with the requirements of the fictitious business name statutes (Bus & P C §§17900–17930).

The partnership's compliance with applicable federal, state, and local laws is relevant in establishing recognition of the partnership for tax purposes, as well as of a donee-partner as a "real owner" of a partnership interest. See Reg §1.704–1(e)(2)(vi).

1.3. *Purpose.* The purpose of the Partnership is to acquire, own, manage, lease, and hold for investment those assets listed on Exhibit B, attached hereto, and/or any different or additional assets acquired by the Partnership. The purpose of the Partnership shall specifically include the sale or exchange of Partnership assets and the purchase and acquisition of other assets for business or investment purposes.

COMMENT: The partnership must have a business purpose. Corp C §15006. The purpose clause should be broad enough to allow for the sale of partnership assets and the retention of income and sales proceeds for future investment. Failure to distribute income to a donee-partner is a factor indicating that the donee-partner is not a "real owner" of a partnership interest, resulting in the donee-partner not being recognized as a partner for tax purposes. Income may be accumulated, rather than distributed to the partners, if warranted for reasonable business and investment needs of the partnership. See Reg §1.704–1(e)(2)(v); see also The "Real Owner" Test, p 186.

1.4. *Term.* The term of the Partnership shall commence on the date the Certificate of Limited Partnership described in §15621 of the Act is filed with the Office of the Secretary of State of the State of California, and shall continue until December 31, 2015, unless earlier termination is provided in this Agreement.

COMMENT: The partnership should have a set term in order to minimize the risk of having the corporate characteristic of continuity of life. Also, unless the partnership agreement provides for the time or specifies the events on which the partnership will terminate, a limited partner would have the right to withdraw from the partnership on six months' prior written notice to the general partner. Corp C §15663. On withdrawal (unless otherwise provided in the partnership agreement), the withdrawing partner is entitled to receive the fair value of his or her interest. Corp C §15664. Specifying in the agreement when a limited partner may withdraw will eliminate the limited partner's ability to unilaterally withdraw from the partnership on six months' notice.

ARTICLE II

CAPITAL CONTRIBUTIONS

2.1. *Capital Contributions.* Each Partner shall contribute to the capital of Partnership the amount of cash and/or other property listed on Exhibit A. The capital account of each Partner shall be credited with such Partner's capital contribution in the amount of cash and the fair market value of other property contributed by such Partner to the capital of the Partnership.

COMMENT: To rely on the family partnership rules in characterizing a limited partner as a "real owner" of a partnership interest, capital must be "a material income-producing factor" in the partnership. IRC §704(e)(1). Partnership capital therefore should consist primarily of income-producing assets. When any limited partner's interest in partnership capital is acquired by gift or purchase from a family member, the partnership should not hold assets in which the donor-partner retains any interest other than by virtue of his or her interest in the partnership. For example, it is best that the partnership not hold the personal residence of the donor-partner, in which the donor-partner continues to reside after contribution to the partnership. Personal use of the partnership assets by the donor-partner (at least when the donor partner does not pay full and adequate consideration for such use) may result not only in the full value of the asset being taxable in the donor-partner's estate, but also may jeopardize recognition of the donee-partner as a partner for tax purposes, because the donee-partner is deprived of the benefit of his or her capital. See The Family Partnership Rules, and Gifting Partnership Interests While Retaining Control, pp 186 and 188.

2.2. ***No Additional Capital Contribution Required of Limited Partners.*** **The Limited Partners shall not be required to make any contributions to the capital of the Partnership other than their initial capital contribution.**

2.3. ***Voluntary Additional Capital Contributions.*** **Limited Partners may voluntarily make an additional capital contribution to the Partnership only with the prior consent of the General Partner. Except as provided below, the General Partner may make an additional capital contribution to the Partnership only with the consent of a majority in interest of the Limited Partners. Notwithstanding the foregoing, the General Partner may make an additional contribution to the capital of the Partnership without the consent of the Limited Partners, provided such contribution is allocated among, and credited to, the capital accounts of all Partners (including the contributing General Partner) in accordance with each Partner's percentage interest in the profits and losses of the Partnership as of the date of the contribution. The contributing General Partner shall be responsible for filing any federal gift tax returns required to be filed, and the payment of any gift tax required to be paid.**

COMMENT: Income allocations in a family partnership must be made in accordance with each partner's interest in partnership capital. Therefore, any additional contribution to the capital of a partnership will require a readjustment of each partner's interest in partnership profits. If it is anticipated that the general partner will make additional contributions to the capital of the partnership after its formation, allocating that contribution among the partners in accordance with their interest in the partnership (constituting a gift of capital to each of the partners) will allow profit-sharing percentages to be maintained. See The Annual Gift Tax Exclusion, p 189.

CAVEAT: This provision should be carefully considered before inclusion. It provides for an automatic gift to the remaining partners of a portion of any capital contribution made by the general partner without the consent of the limited partners. Additional capital may be needed by the partnership, even though the contributing general partner may not want to make additional gifts to the limited partners (or to all the limited partners). To provide for this contingency, if this provision is included, the partnership agreement should also allow the general partner to make loans to the partnership. These loans should be properly documented and carry a reasonable rate of interest, which should actually be paid by the partnership. Loans do not increase a partner's capital account, and hence will not affect profit-sharing ratios.

If the contributing general partner's additional capital contributions are not automatically allocated among all partners, and if the contributing general partner also holds an interest in the partnership as a limited partner, the general partner may gift an additional limited partner's interest in the partnership to one or more of the limited partners to account for the adjustment in each partner's percentage interest, or gift directly to one or more limited partners an interest in the property to be contributed, before contribution. If the cash or property to be contributed to the partnership is first gifted directly to one or more of the limited partners before contribution, the gift will be valued, for gift tax purposes, in accordance with the value of the interest in the assets transferred, which may be greater than the gifting of additional partnership interests after contributing the asset to the partnership. See Leveraged Giving Through Valuation Discounts, p 190.

2.4. *Limited Withdrawal Rights.* For a period of thirty (30) days following any additional capital contribution made to the Partnership by the General Partner, which contribution results in an increase in the capital accounts of Partners other than the contributing Partner, each Partner, other than the contributing Partner, shall have the right to withdraw an amount equal to the increase in his or her capital account (except for an additional capital contribution specifically excluded from withdrawal, as provided below), subject to the limitations hereinafter set forth.

COMMENT: To qualify a gift for the $10,000 annual exclusion under IRC §2503(b), the gift must be one of a "present interest." Because a limited partner generally may not demand return of capital except on dissolution of the partnership, a question arises whether the limited partner's right to sell his or her interest (typically subject to restrictions in the partnership agreement) is sufficient to constitute a gift made to his or her capital account as a present interest. See The Annual Gift Tax Exclusion, p 189, for a discussion of Crummey-type withdrawal rights as a device for qualifying the gift for the annual exclusion, and recent IRS Letter Rulings 9131006 (reported at 13 CEB Est Plan Rep 56 (Oct. 1991)), and 9415007, holding that a gift of an interest in a limited partnership qualifies for the annual gift tax exclusion, despite retained control over distributions by the general partner.

CAVEAT: Granting a limited partner the right to withdraw certain capital increases may negatively affect valuation discounts as well as creditor protection. Because of the limited withdrawal right, however, both in time and amount, the negative effect on both of these factors should be minimal.

If the limited partner is a trust, unless it is a "minor's trust" under IRC §2503(c), the beneficiary must have withdrawal rights under the trust instrument to qualify the gift for the annual exclusion. See Minors, Trusts, and Limited Partners, p 187.

2.5. *Notice of Right To Demand Withdrawal of Additional Capital Contribution.* The General Partner shall promptly give written notice to each Partner of each Additional Capital Contribution made to the partnership. Such notice shall include a description of the property contributed, the respective right of withdrawal by the Partner resulting from the contribution, and the time within which the right must be exercised. Such notice shall not be a condition precedent to, or in any way affect any Partner's immediate right to withdraw his or her share of the Additional Capital Contribution, subject to limitations contained in this Article II.

2.6. *Exercise of Withdrawal Rights Over Additional Capital Contributions.* Any Partner entitled to withdraw an increase in such Partner's capital account resulting from an Additional Capital Contribution by the General Partner may exercise that right only by written request timely delivered to the General Partner.

2.7. *Amount of Additional Capital Contribution That Can Be Withdrawn by a Noncontributing Partner.* Following an Additional Capital Contribution to the Partnership by a Partner, each Partner (other than the contributing Partner) may withdraw from such Partner's capital account an amount equal to the *lesser* of that Partner's increase in such Partner's capital account resulting from the Additional Capital Contribution, and the amount that qualifies for the annual gift tax exclusion under Internal Revenue Code §2503(b) for gifts during any calendar year from one donor to one donee.

COMMENT: The withdrawal right is limited to the amount that will qualify for the annual gift tax exclusion under IRC §2503(b).

CAVEAT: If the limited partner fails to exercise his or her Crummey power withdrawal right (as is expected), there are potential income tax and gift tax consequences. Technically, the limited partner would be taxable on the income generated on the amount he or she could have withdrawn, for the period of time he or she could make the withdrawal. However, because a withdrawal from the partner's capital account would have reduced that partner's profit and loss percentage in the partnership, there should be no significant additional income attributable to the partner. Further, in a trust context, the lapse of a Crummey power (at least to the extent that it exceeds the five-or-five limit (IRC §2514(e)), if applicable, usually results in a gift to the remainder beneficiaries of the trust. However, in a partnership context, the funds remain in the partner's capital account, and ultimately will be distributable to that partner. It therefore appears that the lapse of a Crummey power should not have significant income tax, gift tax, or estate tax consequences on the limited partner, but this result is by no means certain, and the potential for such tax consequences should be taken into consideration before including a Crummey power-type capital account withdrawal right in favor of limited partners.

2.8. *Power of a Contributing Partner To Prevent Withdrawal of Additional Capital Contribution.* Notwithstanding the foregoing provisions of this Article II, the contributing Partner of any Additional Capital Contribution to the Partnership shall have the power to prevent the withdrawal of the Additional Capital Contribution by the remaining Partners by accompanying the contribution with a written notice that the contribution will not be subject to withdrawal under the provisions of this Article II.

COMMENT: This provision allows for flexibility to determine whether the benefits of qualifying the gift for the annual exclusion outweigh the risk that the withdrawal right will be exercised against the wishes of the contributing partner. See The Annual Gift Tax Exclusion, p 189.

2.9. *Return of Capital.* Except as otherwise provided in this Agreement, no General Partner or Limited Partner shall have the right to demand or receive the return of his or her capital contribution. Under circumstances requiring the return of any capital contribution, no Partner shall have the right to receive property other than cash except as may be specifically provided herein.

COMMENT: Because one of the principal purposes of gifting interests in a limited partnership rather than direct gifting of the underlying assets is for the donor to retain control over the assets, it is important that a limited partner not be able to "cash in" his interests in the partnership. Further, if a partner were entitled to a return of his capital account on exercise of a voluntary right to withdraw, such right could also be exercised by a creditor partner who obtained a charging order (a court-ordered assignment of the debtor-partner's rights to receive distributions from the partnership) against the partnership interest. See Gifting Partnership Interests While Retaining Control, and discussion regarding charging orders in Insulating Partnership Assets From Claims of Creditors of Partners, pp 188 and 193.

2.10. *Capital Accounts.* A separate capital account shall be maintained for each Partner in accordance with Treasury Regulation §1.704–1(b).

COMMENT: Because distributions and allocations will be made in accordance with capital accounts, it is essential that capital accounts be properly maintained in accordance with IRS regulations. Allocations in the partnership agreement will be respected only if they have "substantial economic effect." One of the requirements to satisfy the substantial-economic-effect test is that capital accounts be maintained in accordance with Reg §1.704-1(b)(2)(iv). See Requirement of "Substantial Economic Effect," p 185.

ARTICLE III

PAYMENTS, ALLOCATIONS, AND DISTRIBUTIONS

3.1. *Payments to General Partner.* To the extent that the Partnership generates income as a result of the services of the General Partner, or if the General Partner otherwise performs services for or on behalf of the Partnership, the General Partner shall receive a salary from the Partnership equal to the fair value of all services rendered to the Partnership by the General Partner. Such salary shall compensate the General Partner for the reasonable value of his or her services, based on what the Partnership would be required to pay an unrelated third party for comparable services. Salary payments to the General Partner for services rendered shall be determined without regard to the income of the Partnership, and shall be "guaranteed payments" within the meaning of Internal Revenue Code §707(c), and the regulations thereunder; provided, however, that in the event the Partnership does not have sufficient funds with which to satisfy its salary obligation to the General Partner, the General Partner agrees to defer receipt of such salary until such time as it can be paid by the Partnership.

COMMENT: This provision meets the requirement that a service partner be adequately compensated for services to the partnership, even though capital is the "material income-producing factor." These payments are ordinary income to the service partner, deductible by the partnership, and do not affect the partner's capital account. See Application of General Income Allocation Rules, p 186, for a discussion of allocation of income constituting a violation of the prohibition against assignment of income.

An investment partnership may not have sufficient liquidity to compensate a general partner who is providing continual management services to the partnership. If the general partner is both the payee and in charge of the payor (the partnership), and

voluntarily defers the salary payment, without an obligation to do so, he or she may nevertheless be taxed on the income on the theory of "constructive receipt." If the partnership agreement requires the general partner to defer salary if there is insufficient cash flow to make payments, he or she should not be taxed on the income before actual receipt.

3.2. *Allocations of Net Profit and Net Loss.* Net profit and net loss shall be allocated to the Partners in accordance with their Percentage Interests in the Partnership. The Percentage Interest of a Partner shall be calculated by dividing each Partner's capital account by the capital account of all Partners.

COMMENT: Internal Revenue Code §704(e)(2) requires that a donee-partner's income allocation not be proportionately greater than the income allocation of the donor-partner, based on their respective interests in the capital of the partnership. See Requirement of "Substantial Economic Effect," p 185.

3.3. *Distributions From Operations.* Except as otherwise provided in this Agreement, net profits from operations, if any, shall be distributed annually (or at more frequent intervals, in the sole discretion of the General partner) in the following order and priority:

a. First, to the Partners in payment of interest accrued on loans by a Partner to the Partnership.

b. Second, to the Partners in payment of their principal on loans, if any, to the Partnership.

c. The balance, if any, to the Partners in accordance with their Partnership Interest Percentages.

COMMENT: The right to receive income from the partnership is an important consideration in determining whether a donee-partner is the "real owner" of the partnership interests. See Reg §1.704–1(e)(2)(ii)(A) regarding the retention by the donor-partner of excessive control over income distributions. See The "Real Owner" Test, p 186.

3.4. *Distributions From Sales and Refinancing.* Except as otherwise provided in this Agreement, the net proceeds from the sale or refinancing of Partnership assets shall be distributed to the Partners at the end of the calendar year in which the sale or refinancing occurred (or sooner, in the discretion of the General Partner) in accordance with each Partner's Percentage Interest in the Partnership.

3.5. *Retention of Reserves.* The General Partner shall retain from cash otherwise distributable to the Partners, as a reserve account, sufficient working capital to provide for the anticipated needs and expenses of the Partnership, including the retirement of Partnership debt, and to enable the Partnership to make additional investments, as investment opportunities arise. The Partners acknowledge that reserves may be established for the purpose of making future investments, even though no particular investment has been specifically identified for consideration by the General Partner.

COMMENT: A general partner will not be deemed to have retained too much control over income distribution by reason of exercise of the right to retain income in the partnership for reasonable needs of the partnership business. If the partnership is an investment partnership, accumulating funds for future investment should not be deemed

to be excessive control of the partnership income distributions. See The "Real Owner" Test and Distribution of Profits, pp 186 and 194.

3.6. *Distributions on Dissolution of Partnership.* Following the termination and dissolution of the Partnership, the Partnership will continue solely for the purpose of winding up its affairs, liquidating its assets, satisfying the claims of its creditors, and distributing the balance of its assets to the Partners. The assets of the Partnership (after liquidation, if necessary) shall be distributed as follows:

a. First, to the payment and discharge of all Partnership debts and liabilities to creditors other than the General Partner.

b. Second, to the payment and discharge of all Partnership debts and liabilities to the General Partner, including the amount of any unpaid deferred salary payment to the General Partner.

c. Third, to each Partner, in proportion to each Partner's capital account, until each Partner's capital account is reduced to zero.

d. The balance, if any, shall be distributed to the Partners in accordance with their Percentage Interests in the Partnership.

ARTICLE IV

TRANSFERS OF INTERESTS

4.1. *Restriction on Transfer.* Except as otherwise provided in this Agreement, no Limited Partner shall transfer, pledge, or otherwise encumber all or any portion of his or her interests in the Partnership.

COMMENT: A limited partner who is absolutely prohibited from selling his or her interests in the partnership, or is required to suffer "financial detriment" (*i.e.,* sale of his or her interests back to the general partner or the partnership at a bargain price) will not be deemed the "real owner" of the partnership interests. However, reasonable restrictions on transfer are acceptable.

4.2. *Permitted Transfers.* Subject to the conditions and restrictions set forth herein, a Limited Partner may at any time transfer all or a portion of his or her interests in the Partnership to (a) any other Partner; (b) any member of the transferor's immediate family; (c) a trust in which all of the principal beneficiaries consist of one or more of the group consisting of the Partner, the Partner's spouse, and issue of the Partner and/or the Partner's spouse; (d) the transferor's executor, administrator, trustee, or personal representative to whom such interests are transferred at death or involuntarily by operation of law; or (e) any purchaser, after compliance with the requirements of §4.3.

COMMENT: A limited partner should be free to make transfers affecting merely the form in which he or she holds an investment, or among his or her family members, for estate planning purposes.

4.3. *Right of First Refusal.* _ _[*Insert standard provision regarding right of first refusal*]_ _. **See Advising California Partnerships §5.132 (2d ed Cal CEB 1988).**

COMMENT: The right of first refusal may be offered first to the general partner and then to the limited partners, or to all partners simultaneously. The price to the partners for the interest offered should be the price agreed to be paid by the third party. If the partners may exercise the right of first refusal at a pre-set artificially low price, the selling partner may not then sell his or her interest without suffering "financial detriment," thereby affecting whether the partner is a "real owner" of his or her partnership interests.

4.4. *Rights of Unadmitted Assignees.* Any assignment of a Partner's interest in the Partnership, in whole or in part, will not cause the dissolution of the Partnership. A person who acquires an interest in the Partnership but is not admitted as a substituted Limited Partner pursuant to §4.5 hereof, including a person who acquires the interest by levy, charging order, foreclosure, or other similar proceeding, shall be entitled only to allocations and distributions with respect to the interests acquired in accordance with this Agreement, and shall have no right to examine the books and records of the Partnership, receive any information regarding the Partnership affairs, or exercise any other rights of a Partner, General or Limited.

COMMENT: A creditor of a partner obtaining a charging order against that partner's partnership interest will have the rights of an assignee. Those rights should be limited to the right to receive any distribution and allocation that would attach to the interest. Because an allocation will carry with it a tax liability for the income allocated, whether or not a distribution is actually made, a charging order on an interest in a partnership in which distributions can reasonably be anticipated to be less than the tax liability associated with the taxable income allocated is not an attractive asset to a creditor. See Insulating Partnership Assets From Claims of Creditors of Partners, p 193.

4.5. *Admission of Transferees as Partners.* A permitted transferee of an interest in the Partnership may be admitted to the Partnership as a substituted Limited Partner only on satisfaction of the following conditions:

a. The consent of the General Partner, which consent may be given or withheld in the sole and absolute discretion of the General Partner;

b. Delivery by the assignor to the General Partner of a signed and acknowledged request that the assignee be admitted as a substituted partner;

c. The unanimous consent of the remaining Limited Partners;

d. Execution by the assignee of an amendment to the Partnership Agreement, agreeing to be bound by the terms and provisions thereof; and

e. Payment by the assignee of a reasonable transfer fee, as shall be established by the General Partner.

COMMENT: The general partner should be able to refuse admitting a transferee as a substituted limited partner, at the general partner's sole discretion, to avoid a transferee being able to compel becoming a substituted limited partner, with all of the rights associated therewith, including voting rights. See Drafting a Limited Partnership Agreement for Asset Protection, p 194.

4.6. ***Assignee of General Partner's Interest.*** **In the event a General Partner's interest is transferred, either voluntarily or involuntarily (specifically including a transfer of rights by levy, charging order, foreclosure, or similar proceeding), such interest shall be converted into the interest of a Limited Partner, and such General Partner will immediately cease to act as General Partner. If there are one or more remaining General Partners, they shall continue to function as General Partners. If the General Partner whose interest was transferred was the sole General Partner, a new General Partner shall be elected by a majority of interests of the Limited Partners entitled to vote. The assignee of the General Partner shall not be entitled to exercise any of the rights of a General Partner, and may not interfere with the operation or management of the Partnership in any manner.**

COMMENT: A creditor of the general partner should not be entitled to exercise any of the general partner's rights to liquidate assets or control distributions. See Insulating Partnership Assets From Claims of Creditors of Partners, p 193.