
Chapter 15

Partnerships

Most family forest land traditionally has been operated as sole proprietorships or in joint fee ownership. Increasingly, however, nonindustrial forest landowners are turning to partnerships, limited liability companies (LLCs), and corporations as the entities of choice. This particularly is true if two or more persons are involved in the ownership and management. The trend has been accelerated in part due to the increasing financial value associated with managed forest land and the desire to use prudent business and tax practices. In many families, there also is a special interest in using partnerships, LLCs, and corporations for estate planning purposes.

A key factor in selecting a form of organization is whether it is intended that the family forest operation will continue beyond the lives of the current owner(s). If this is not the case, sole proprietorship may be the best vehicle. But if it is expected that the forest as an entity will continue into the next generation, a corporation, LLC, or partnership may be a better choice. Partnerships are discussed in this chapter, corporations in chapter 16, and LLCs in chapter 17.

The General Partnership

A general partnership typically is defined as an association of two or more persons, as co-owners, to operate a business for profit. Legal tests for determining what is and is not a partnership have been developed in each State and vary from one State to another. Written partnership agreements are not necessarily required if the actions of the parties involved and the attributes of their relationship are sufficient to indicate partnership status. Most States require a sharing of profits for a partnership to exist; some also require a sharing of losses. Most States give weight to the way the parties believe they are organized; therefore, it may not be wise to use the term “partnership” in business transactions, discussions with others, or correspondence unless partnership status is desired.

The best procedure is to develop a written partnership agreement that clearly states the provisions governing the arrangement. Unless otherwise specified in the agreement, all partners in a general partnership have an equal voice in managing the business and a majority vote governs. Limited partnerships, as discussed below, are an exception to this rule.

Partnership Mechanics

Partnership accounting procedures define partnership interests in terms of capital, profits, and losses. A partner’s capital interest is measured by his (her) capital account, which reflects that person’s economic stake in the partnership at any given time. Initial contributions are recorded, and are increased to reflect income and decreased to reflect losses and distributions.

Partnership Units

Family partnerships sometimes use partnership units to reflect ownership interests. These are similar to shares of stock and may be represented by paper certificates as is stock. The use of units rather than percentage adjustments on the partnership books makes gifts and sales of partnership interests to family members easier to accomplish. Such transactions can be made simply by transferring certificates.

General Partnership Attributes

Under State law, a general partnership is an entity that may acquire and convey title to property. When the partnership does own property, any partner (except in a limited partnership, as discussed below) may convey title on behalf of the partnership.

Flexibility

Compared to corporations, general partnerships are extremely flexible. The partnership agreement can be amended to realize favorable economic and tax outcomes up to the time the partnership income tax return is filed. This additional flexibility in structuring financial arrangements, however, may lead to a substantially more complex partnership agreement as well as increased scrutiny under the Federal income tax law.

Contributions—Contributions to partnerships need not be equal among partners. Contributions of property to a partnership may be made without recognition of gain; in some cases, this is not possible with a corporation. Generally, assets brought into the partnership or bought with partnership funds become partnership property. The partnership adopts the partner’s basis for property transferred to it, and in turn, the contributing partner’s capital account adopts the basis of the transferred property.

Withdrawals—The ability to withdraw property from a partnership without adverse tax consequences is a significant advantage. The distribution of property other than cash by a partnership to its partners normally is not subject to taxation. Instead, the partner receives the property with a carryover adjusted basis, unless the distribution is made in liquidation of a partner's interest. In that case, the adjusted basis of the property is determined with reference to the adjusted basis of the partner's partnership interest. In contrast, corporate distributions are treated as dividend payments or—if made as liquidating distributions—as payments in exchange for stock. Finally, liquidation of a partnership generally is a nontaxable event; this generally is not the case with a corporate liquidation.

Unlimited Liability

Perhaps the best known characteristic of a general partnership is the unlimited liability of all partners for obligations of the partnership. The partnership creditors must first make a claim against the partnership assets; if any debt remains, they then can make a claim against the personal assets of the individual partners. Also, creditors of an individual partner can make a claim against the partnership assets up to the amount of that partner's interest. These rules do not apply to the limited partners in a limited partnership, as discussed below.

Management Rights

In a general partnership, all partners have equal rights in the management and conduct of the business. No one can become a member (partner) of the partnership without the consent of all the members. Both of these rules, however, are subject to any agreement to the contrary among the partners. Thus, while State corporate statutes establish specific requirements relating to voting rights within a corporation, partnership statutes permit almost complete flexibility, subject to the requirement that the partners all agree.

Partners as Agents

Typically, every partner in a general partnership is an agent of the partnership for purposes of its business and any action by a partner within the scope of business will bind the partnership. Partnership liability does not result, however, if the partner has no authority to bind the partnership—for example, if the partner is a minor—and the party with whom the partner is dealing has knowledge of that fact.

Assignment of Partnership Interest

A partner's assignment of interest in the partnership does not automatically entitle the assignee to participate in the business. Unless the assignee is accepted as a partner by

agreement of all the original partners, the assignee merely is entitled to receive a share of the partnership profits.

Partnership Taxation

Partnerships are not taxable entities in and of themselves. Although a partnership files an income tax return at the partnership level, it is only an information return. Income or losses are passed through to each individual partner in proportion to his (her) interest in the partnership.

Partnership Termination

A general partnership may not have as much stability as the members would like. As with a sole proprietorship or joint ownership, a general partnership may be vulnerable to premature liquidation in the absence of prior planning. If there is a written partnership agreement, the term of existence can be stated. Usually, however, partnership agreements provide that the partnership exists at the will of the partners. Even though a term of existence may be specified, the courts generally do not force continuation of the partnership against the desire of a partner to withdraw. Dissolving partners have three choices: (1) liquidate, (2) form a new partnership, or (3) shift to a sole proprietorship or corporation.

On the death of a partner, the surviving partners usually are under a duty to wind up the business and make a distribution to the deceased partner's estate; however, some courts have recognized the right of the surviving partners to bind the deceased partner's heirs to continue the business. When continuation is desired, a provision should be included in the partnership agreement that requires continuation and gives the executor of each partner the power to act as a partner.

Estate Planning With Partnerships

Minors as Partners

Estate planning for members of a family partnership often involves transfer of partnership interests to minors. The intention may be to reduce the family income tax bill, reduce death taxes, or simply move older children into the business, but minors as partners can create problems. For Federal income tax purposes, a minor is not recognized as a partner unless control is exercised by another person for the benefit of the minor or the minor is competent to manage his (her) own property and participate in the partnership activities in accordance with his (her) interest in the property. The test of competency is whether the minor has sufficient maturity and experience to be competent in business dealings, regardless of State law.

Unless a minor has significant involvement in the management of the partnership, the interest probably should be conveyed to a trustee, both for the minor's benefit and to conform to Internal Revenue Service (IRS) regulations that require adequate judicial supervision. A minor may, however, be a limited partner because—as discussed below—limited partners are precluded from management. In any event, a gift of a partnership interest should be made only in accordance with the Uniform Gift to Minors Act as discussed in chapter 8.

Retained Control

Whether the donor of a partnership interest should retain control of the partnership usually is a nontax matter involving basic personal goals. Retention of control, however, may involve significant income and estate tax consequences. The owner of a capital interest in a partnership structured around family forest land will be recognized as a partner for income tax purposes, whether the owner received the interest by purchase or by gift. Retained control over a gifted interest may cause the donor to be treated as the owner for income tax purposes. Whether the retained controls are significant enough to cause such a result is a question of fact. This problem can be circumvented with a limited partnership.

Spousal Partnerships

The situation of spouses who jointly own and manage forest land can be confusing as to whether or not a partnership actually exists. If the joint activity constitutes and is treated as a business, there is a presumption that the activity is a partnership. Under a provision of the Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28), however, spouses who conduct a qualified joint venture and who file a joint Federal income tax return can elect to be treated as two sole proprietorships rather than a partnership for tax purposes. A qualified joint venture is any joint activity involving the conduct of a trade or business, if: (1) the husband and wife are the only members of the joint venture; (2) each qualifies independently as a material participant in the trade or business according to the passive loss rules, without regard to the rule that treats participation by one spouse as participation by the other; and (3) both elect for the provision to apply. If the spouses make this election, all items of income, gain, loss, deduction, and credit are divided between them according to their respective interests in the venture, each files his (her) own business and self-employment tax forms, and each receives credit for paying Social Security and Medicare taxes.

Limited Partnerships

Limited partnerships are closer in structure to corporations than are general partnerships. In most States, a partnership may be organized with one or more limited partners if there is at least one general partner. Limited partners do not have personal liability beyond their investments in the partnership. The price of this status is that limited partners may not participate in management; only general partners have management authority.

A limited partner who does participate in management may become liable as a general partner. Nevertheless, the limited partnership provides an ideal vehicle for excluding family members such as minors and distant co-owners from management control. A limited partnership also may be useful if one of the partners, such as a parent, wishes to withdraw from active participation in management of the family forest land. It permits the parent to leave capital invested in the partnership without the fear of unlimited liability.

Unlike a general partnership, which requires no formal action other than agreement among the partners, a limited partnership must be formed in compliance with specific State law. This requires the execution of a certificate of limited partnership which is placed on file with a public official, usually the county clerk.

Family Limited Partnerships

A family limited partnership (FLP) typically is created for estate planning purposes by transferring family assets likely to appreciate rapidly to a new limited partnership created under the law of the applicable State. In exchange for the assets, the transferor generally receives a very small general partnership interest (typically 1 to 2 percent) and a large limited partnership interest. The transferor retains the general partnership interest and over a period of time transfers limited partnership interests to family members—usually children. The interests received typically are minority interests. The general partnership interest gives the transferor control over operation of the business even though that interest represents only a small percentage of the value of the business.

Tax advantages—Limited partnership interests transferred to children under an FLP are worth significantly less for gift tax purposes than the value of the same proportional interest in the underlying assets. The holder of a minority limited partnership interest cannot make decisions about how the business is run, demand distributions, or force a liquidation of the partnership. In addition, an interest in an FLP may be far less marketable than an interest in the underlying assets of the business. Accordingly, as discussed

in chapter 4, minority interest and lack of marketability discounts generally are allowed on the transfer of interest in an FLP. The combined discount for a minority interest and lack of marketability typically is in the 20 to 40 percent range, but can be even higher.

Nontax advantages—A family limited partnership also provides certain nontax advantages which include: (1) the ability to retain control over transferred assets; (2) ease of probate; (3) ease of amendment of the partnership operating structure; (4) protection from creditors; and (5) facilitation of use of the gift tax annual exclusion.

IRS Attacks on Family Limited Partnerships

The sham transaction doctrine—In IRS Technical Advice Memorandum 9719006 (January 14, 1997), the IRS launched a major attack on FLPs. Under the facts of this ruling, assets were transferred from two trusts to an FLP that was created two days before the decedent's death. Immediately after the FLP received the assets, limited partnership interests were transferred to the transferor's children. The IRS ruled that valuation discounts, claimed with respect to the FLP transaction, should be disallowed under either of two theories. One theory was that, consistent with the sham transaction doctrine, the formation of the partnership interest should be treated as a single testamentary transaction; therefore, the partnership should be disregarded for estate tax valuation purposes.

The alternative theory of the IRS was to apply Internal Revenue Code (IRC) section 2703 to the transaction, with the result that, for transfer tax purposes, the value of the property is determined without regard to any option, agreement, or other restriction on the right to sell or use the property. The purpose of section 2703 is to prevent possible distortions in value that might result if a transferor retained certain rights or imposed certain restrictions with respect to the transferred property without intending to exercise the

rights or restrictions. The estate argued that the property transferred was the partnership interests and—because there were no restrictions in the partnership agreement relating to the transferees' ability to sell, transfer, or use the interests—section 2703 did not apply. The IRS disagreed, taking the position that what the children really received was the underlying assets subject to the partnership agreement. Thus, the partnership agreement was a restriction within the meaning of section 2703, and any reduction in value caused by the partnership agreement was to be disregarded under section 2703 unless the bona fide business arrangement exception of section 2703(b) was applicable.

The IRS concluded that even if the steps of the transaction were not collapsed and the partnership interests, rather than the underlying assets, were treated as the subject of the transfers, section 2703 still would apply. This is because under Treasury Regulation 25.2703-1(a)(3), a section 2703 restriction either can be contained in a partnership agreement or implicit in the capital structure of the partnership.

Applicable restrictions under IRC section

2704—Citing the underlying Code and Regulations, the IRS has published several Technical Advice Memoranda denying FLP valuation discounts that were deemed to relate to “applicable restrictions.” With respect to an FLP, an applicable restriction is one that effectively limits the transferor or any donee of a partnership interest from removing a restriction preventing liquidation of the partnership. Treasury Regulation 25.2704-2(b) provides that a limitation on the ability to liquidate the partnership that is more restrictive than the limitations that would apply under State law in the absence of the restriction will be deemed an applicable restriction for purposes of IRC section 2704. If an applicable restriction is disregarded, the transferred interest is valued as if the restriction did not exist and as if the rights of the transferor were determined under the State law that otherwise would apply.