Family Partnerships for Tax Savings

For tax and estate planning purposes many wall and ceiling contractors are turning to family partnerships

(Editor’s Note: This article on family partnerships for holding real estate was written by Howard E. Needleman, National Services Director for Real Estate, and Robert E. Zobel, supervisor, both of the Philadelphia office of Touche Ross.)

An effective vehicle for both tax and estate planning is the use of a family partnership to hold real estate. A strategy of tax planning is to shift income from a high-bracket taxpayer to family members in lower tax brackets. Similarly, estate planning, through the transfer of property from the donor to younger generation donees, minimizes or postpones estate tax liability.

The ideal situation for creation of a family partnership occurs when the taxpayer owns property which generates taxable income and which is likely to increase substantially in value in future years. Of course, it is most beneficial if the donor has a substantial estate and does not need the income generated by the property.

As an example of the savings available though use of a family partnership, let’s assume that the father of two children (ages seven and nine) is in the 50% tax bracket and has a substantial estate. He purchases a rental property for $1,000,000 ($50,000 in cash and a mortgage of $950,000). But, instead of holding a 100% interest in the property, the father sets up a family partnership in gifting to each of his children a 25% interest in the property. The value of the interest transferred to the children is $25,000 (50% of the equity in the property). Assuming 1) there is no gift tax on the transfer, 2) the property generates taxable income of $10,000 per year, 3) the mortgage is reduced by $250,000 over 10 years and 4) the property is worth $1,250,000 after 10 years, the savings achieved after 10 years would be:

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<thead>
<tr>
<th></th>
<th>Income Taxes</th>
<th>Taxable Value</th>
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<tbody>
<tr>
<td>No partnership created</td>
<td>$50,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Family partnership created</td>
<td>35,000(^1)</td>
<td>275,000(^2)</td>
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Savings as a result of Family partnership $15,000 $225,000

To achieve these savings, however, proper structuring and planning must be exercised in the formation of the family partnership.

\(^1\)50% of $50,000 plus 20% of $50,000 = $35,000
\(^2\)Value of interest $250,000 plus add-back of gift of $25,000 required by 1976 Tax Reform Act.

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Family partnerships present problems of intrafamily assignment of income rather than problems of partnership taxation. The cornerstone of family partnerships is found in the U.S. Supreme Court case of Commissioner v. Culbertson.

In this case, Mr. Culbertson bought out his business partner with the condition that Mr. Culbertson resell the purchased interest to his sons at the buy-out price. A new partnership was formed between Mr. Culbertson and his sons. The sons paid for their interest with notes, which were satisfied by a combination of forgiveness of debt by Mr. Culbertson and a commercial bank loan taken out in the name of the new partnership. The partnership complied with all legal and administrative requirements to be recognized as a partnership and ultimately paid off the bank loan. However, the Internal Revenue Service taxed all the partnership income to Mr. Culbertson, contending that the contribution of “vital services” or “original capital” was required for the recognition of a family partnership. The high court, however, discarded the application of the objective standards proposed by the IRS and held that the key question is “whether, considering all the facts . . . the parties in good faith and acting with a business purpose intend to join together in the present conduct of the enterprise.”

While the Supreme Court clarified the issue of family partnerships through the Commissioner v. Culbertson decision, lower courts experienced difficulty in applying the high court’s standard. Congress was ultimately compelled to enact legislation adding Sections 191 and 3797 (a) (2), or the “Family Partnership” Sections, to the Internal Revenue Code of 1939. These provisions were re-enacted as Section 704 (e) of the 1954 Internal Revenue Code.

Requirements of a Family Partnership

An individual is recognized as a partner in a family partnership if he owns a capital interest in the partnership regardless of the source from which the interest is derived. Capital in the partnership must be a material income-producing factor and the reality of the partnership must be established.

Capital interest. Capital interest in the partnership occurs when a partner has an equity in the partnership assets. This is reflected by a proprietary interest in the partnership assets, including all accretions distributable to the partners upon dissolution of the partnership. The right to participate in the earnings and profits of a partnership does not represent a capital interest.

Capital as a material income-producing factor. Capi-
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Tal is a material income-producing factor in a family partnership where a substantial portion of the gross income of the business is derived from the partnership capital invested in the business. This occurs, for instance, when the partnership business requires substantial inventory or investment in plant, machinery, equipment, or real estate.

Reality of the partnership. A family partnership qualifies as a partnership when the new partner actually owns an interest in the business. The new partner does not need to participate in the business to substantiate the reality of the partnership, particularly when capital is a necessary element of transfer and the gift is bona fide. This is true regardless of the motivation behind the transfer or whether the business benefited by the addition of the new partner. Where non-tax motives are evident (for example, when the donee is to be the donor’s successor in the business or the donee is given a financial stake in the family partnership), the Internal Revenue Service will not attempt to establish tax avoidance motives.

Requirements of Ownership

Before a family partnership is established, the parties involved must be properly resolved that ownership and control of the distributed capital interest belongs to the donee.

The IRS may rule adversely against a parent who, in transferring a partnership interest to his child, continues to maintain controls over the interest which are inconsistent with the child’s actual ownership of the interest transferred. Since control of the interest can be retained by the donor through numerous methods, ownership by the donee must be proved under a variety of circumstances, as follows:

Control over distribution of income. Control over distributed income is evidence of control of the interest by the donee. The actual distribution to a donee of a major portion of his distributive share of the partnership will be substantial evidence of the reality of the donee’s interest.

Restriction on the right of donee to withdraw from the partnership. The donee must be entitled to liquidate his interest in the partnership. This requires that the donee be independent of the donor and mature enough to make independent decisions. (If the donee is a minor, the interest may be transferred to a guardian or trust, as discussed below.)

Control of assets essential to business of the partnership. In those situations where the donor has indirect control of assets essential to the partnership through a separate business, trust, estate, individual, or another

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partnership, the reality of the donee’s ownership will be judged as though the indirect controls were exercised directly.

Unusual management powers. The donee’s substantial participation in the management of the business is strong evidence of his exercise of dominion and control over his interest. The donor may retain managerial control if the donee is a limited partner and cannot participate in the management of the partnership by the nature of the business entity.

Strategy of Estate Planning

In establishing a family partnership, the parties should consider the best means of receiving the maximum allowable benefits of tax and estate planning. One such method is through gifting a partnership interest.

In planning inter vivos gifts of a partnership interest, consideration should be given to:

1. Estate liquidity (i.e., having sufficient liquid assets to pay estate taxes);
2. Maximum use of the gift and marital tax deduction, with no or as little tax as possible;
3. Life income to the surviving spouse.

Transfer through gift. A family partnership can be established by gift even though the donee-partner renders no services to the partnership. However, the potential gift tax liabilities must be considered. The gift tax is a current obligation, and raising the funds to pay a sizable obligation may present a problem.

Even though the law now eliminates the distinction between gift and estate tax rates, substantial estate taxes may be saved by making a current gift. Increases in the value of the donee’s partnership interest escape taxation in the donor’s estate. As we saw in our first example, only $25,000, the amount of the original gift, was added back to the father’s estate for the purpose of computing his estate tax. But in fact the children’s interest was worth $250,000.

A further consideration is the potential effect on the donor’s income taxes. Referring again to the first example, by shifting partnership income to his children, the father reduced by 30% the family’s income tax liability on income generated by the property.

However, an income tax cost may be associated with the gifting of a family partnership interest. The gift of a partnership interest reduces the donor’s profit-and-loss interest and his interest in partnership liabilities. The IRS views a reduction in a partner’s share of partnership liabilities as a constructive distribution of cash to him. Thus, the IRS may consider

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the gift as a disproportionate distribution to the donor and tax him to the extent of his share of “hot assets” (i.e., inventory or accounts receivable) gifted away. This is true even when the constructive distribution does not exceed the basis of the donor’s remaining partnership interest.

Gift to minor. Gifts of partnership interest to a minor child is another tactic used in estate planning. For a minor child to be recognized as a partner in the partnership, he must be competent to manage his own property and participate in partnership activities. Lacking proof of his level of competence, the interest of a minor child can be transferred, for his benefit, to a trust or a guardian. Transfer of the child’s interest to a trust offers greater advantages than does transfer to a guardian (particularly in those states whose laws also allow a trust to be a partner). A guardian, unlike a trustee, is subject to judicial supervision, which could include periodic accountings and court approval of transactions.

If the minor’s interest is transferred to a trust, the appointment of an independent trustee would eliminate any potential conflicts of interest. However, the donor may name himself trustee where the gift is bona fide and the donor (grantor) “in his participation in the affairs of the partnership actively represents and protects the interest of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interest to the grantor.”

From a tax standpoint, a wiser course of action by the donor would be to set up an irrevocable trust relinquishing all reversionary interests in the trust corpus. Note that the position of the Internal Revenue Service is that the transfer of a partnership interest to a short-term, reversionary trust (“Clifford Trust”) transfers only an income interest; thus, the IRS will examine such a transfer in terms of the doctrine of “assignment of income.”

Reality of purchased interest. An interest in a family partnership purchased by one family member from another is considered a gift from the seller. The fair market value of the purchased interest is considered donated capital (The “family” of a purchaser is limited to his spouse, ancestors, lineal descendants and trusts for the benefit of these persons.) The purchaser-donee holds his interest with the seller-donor’s basis.

Where a partnership interest is created by an intrafamily sale, on credit or otherwise, one of the following conditions must be met:

1. The terms are those of an arm’s length transac-
tion, particularly with respect to credit, security, interest rates, etc.; or

2. The sale is genuinely intended to promote the

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5 Note that because this involves an intrafamily sale, it is not a “gift” for purposes of Section 2501.

4 Reg. 1.704-1 (e) (2) (vii).

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interests of the business by securing the participation of the buyer.

The reality of the partnership interest is generally recognized when a family member purchases the interest from a partner who is not a member of the family.

Allocation Rules

Serious problems can result from the improper allocation of profits and losses of a family partnership. The two rules peculiar to family partnerships that govern profit-and-loss distribution are these:

1. Reasonable compensation must be allowed for services rendered to the partnership by the donor, even if such compensation is not required in the partnership agreement; and

2. Partnership income must be allocated in proportion to capital interests.

Failures to adhere strictly to these rules will result in the reallocation of partnership profits and losses by the Internal Revenue Service.

Use of Limited Partnership

A family partnership may be operated within the framework of a limited partnership. As general partner, a donor can maintain control over the management of the partnership assets without disqualifying the partnership. Limited partners relinquish control in exchange for limiting their personal liability for damages caused to their investment by partnership activities.

Qualification as a limited partnership for IRS purposes requires —

1. That the limited partner have the capability of assigning his partnership interest.

2. That limited partner’s rights with respect to his investment not be limited to his right to an accounting or to withdrawal from the partnership.

3. A written agreement stating that the general partner should not have unusual discretion in making income distributions to limited partners.

4. That the limited partner subject himself to liability as a general partner if he wants to participate in the management of the partnership.

If a family partnership is also a limited partnership, the donee’s nonparticipation in, and absence of services to, management of the partnership is immaterial as long as all other legal prescriptions are met.

Conclusions

Qualification as a family partnership is exacting. The basic legal requirements must be followed strictly; all partners must be found to own and control their interest; and partnership income must be allocated properly. However, the creative use of a well-conceived family partnership that meets all the requirements of the IRS regulations can result in substantial current tax savings by shifting income from the donor as well as reducing taxes ultimately due on the donor’s estate.