FLP-Limited Partnerships vs. Limited Liability Companies

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FLP–LIMITED PARTNERSHIPS V. LIMITED LIABILITY COMPANIES

A. What is a FLP?

1. Definition of a Partnership. A voluntary association of two or more persons to carry on a business, as co-owners, for profit.

a. Association of Two or More Persons. Partnerships are voluntary associations. All partners must agree to participate. A person cannot be forced to be a partner or to accept another person as a partner.

b. Carrying on a Business. Mere co-ownership of property (by joint tenancy, tenancy in common, tenancy by the entireties, joint property, community property, or otherwise) does not itself establish a partnership. A business -- trade, occupation, or profession -- must be carried on.

c. Co-ownership of a Business. Co-ownership of a business is essential. The most important factors in determining co-ownership are whether the parties share the business' (i) profits and (ii) management responsibility.

d. Profit Motive. The organization must have a profit motive (even though it does not actually have to make a profit).

i. See Holmes v. Lerner (1999) 74 Cal.App. 4th 442, holding that an express agreement to divide profits is not a prerequisite to proving the existence of a partnership.

2. Limited Partnerships. A limited partnership must have at least one general partner (who manages the business and is liable for partnership debts) and one limited partner (who invests capital but does not participate in management). There are no restrictions on the number of general or limited partners allowed. Any person may

be a general or limited partner. A person may be both a general and a limited partner in the same partnership.

a. Admission of New Partners. Once a limited partnership has been formed:

i. New limited partners can be added only upon the written consent of all partners unless the partnership agreement provides otherwise.

ii. New general partners can be admitted only with the written consent of each partner. The partnership agreement cannot waive the right of partners to approve the admission of new general partners.

b. Formation of Limited Partnerships. The creation of a limited partnership is formal and requires public disclosure. The entity must comply with the statutory requirements.

i. Certificate of Limited Partnership. Someone must execute a certificate of limited partnership and file it with the Secretary of State. The certificate must contain:

(a) Name of the limited partnership;

(b) Address of the principal place of business, and the name and address of the agent to receive service of legal process;

(c) Name and business address of each general partner;

(d) The number of general partners' signatures required for filing certificates of amendment, restatement, merger, dissolution, continuation and cancellation; and

(e) Any other matters that the general partners determine to include.

The limited partnership is formed when the certificate of limited partnership is filed.

ii. Defective Formation. Defective formation occurs when (i) a certificate of limited partnership is not properly filed; (ii) there are defects in a certificate that is filed; or (iii) some other statutory requirement for the creation of a limited partnership is not met. If there is a substantial defect, persons who thought they were limited partners can find themselves liable as general partners. Such persons who erroneously but in good faith believe they have become limited partners can escape liability as general partners by either:

(a) Causing the appropriate certificate of limited partnership (or certificate of amendment) to be filed; or

(b) Withdrawing from any future equity participation in the enterprise and causing a certificate showing that withdrawal to be filed.

Nevertheless, the "limited partners" remain liable to any third party who transacts business with the enterprise before either certificate is filed if the third person believed in good faith that the partner was a general partner at the time of the transaction.

iii. Limited Partnership Agreement. The partners of a limited partnership must draft and execute a partnership agreement that sets forth the rights and duties of the (general and limited) partners (including terms and conditions regarding the operation and dissolution of the partnership).

(a) Rights and Duties of Partners. The rights, powers, duties and responsibilities of the partners in a limited partnership are specified in the partnership agreement, CRLPA and the common law. The general partners of a limited partnership have the same rights, duties and powers as partners in a general partnership (1994 Act).

Limited partners can have virtually the same rights as general partners. They have rights to inspect the partnership's books and records and to an accounting. They can assign their partnership interests unless they have agreed otherwise.

(b) Voting Rights. It is good practice to establish voting rights in the partnership agreement.

(c) Share of Profits and Losses. The partnership agreement may specify how profits and losses are to be allocated among the partners. If there is no such agreement, the profits and losses are shared on the basis of the values of the partners' respective capital contributions. A limited partner is generally not liable for losses beyond his or her agreed upon capital contribution.

(d) Other Items/Issues. The partnership agreement should address:

(1) The partnership's name;

(2) The names and addresses of the partners;

(3) The partnership's principal office;

(4) The nature and scope of the partnership business;

(5) The duration of the partnership;

(6) The capital contributions of each partner;

(7) The salaries, if any, to be paid to the partners;

(8) The rights and duties of the partners regarding the management of the partnership;

(9) Limitations, if any, on the authority of partners to bind the partnership;

(10) Provisions for the admission and withdrawal/disassociation of partners, and the terms, conditions, and notices required for withdrawal; and

(11) Provisions for continuing the partnership upon the withdrawal of a partner, death of a partner, other disassociation of a partner, or dissolution of the partnership.

3. Liability of General and Limited Partners. The general partners have unlimited liability for the debts and obligations of the limited partnership. Generally, limited partners are liable only for the debts and obligations of the partnership up to their agreed upon capital contributions.

a. Limited Partners and Management. As a "trade"-off for limited liability, limited partners must give up their right to participate in management. A limited partner is liable as a general partner if his or her participation in the control of the business is substantially the same as that of a general partner (though the limited partner is liable only to persons who reasonably believed him or her to be a general partner).

4. How is a FLP Formed?

a. A partnership agreement is entered into:

i. Individual and trust (Appendix);

ii. Individual and corporation;

iii. Husband and wife;

iv. Etc.

b. Assets are placed into the partnership (the partnership is capitalized).

c. (Limited) FLP interests are gifted to beneficiaries/partners.

B. What is an LLC?

1. General Characteristics. An LLC is a statutory hybrid that is a cross between a corporation and a partnership. LLCs generally provide limited liability to their members (like a corporation) and, at the same time, offer the advantages of one level of tax (like a partnership) without the restrictions placed on S corporations.

a. Formation. LLCs are generally formed upon filing of the Articles of Organization ("Articles").

b. Operation. The internal affairs of the LLC are governed by its Articles, its operating agreement and the applicable state LLC Act – many states have adopted the Revised Uniform Limited Liability Act. The operating agreement looks much like a limited partnership agreement except that the "partners" are referred to as "members" and, in lieu of general partners, the LLC has "managers." Unlike the general partner of a limited partnership, the manager need not own an interest in the LLC. An LLC can be either "member managed," where all of the members are involved in management decisions, or "manager managed," where management responsibilities are delegated to fewer than all of the members.

2. Members and LLC Interests.

a. Nature of Interest in LLC. While an LLC interest is generally considered intangible personal property, a member is limited to the interest itself and has no direct ownership interest in specific LLC assets.

b. Admission of Members. As to the members, admission is generally set out shortly after the time of organization, and thereafter additional persons become members as provided in the Company's operating agreement. If the Articles or operating agreement do not so provide, the unanimous vote of members may be required. Upon an assignment, while the assignee may be entitled to member's share of the profits and losses of the LLC and the right to receive distributions; it does not necessarily include any right to participate in management.

c. Dissociation or Resignation. In many states, a member may not be stopped from dissociation. While the operating agreement may provide for the conditions upon which member may resign or withdraw, the member may dissociate notwithstanding. That action, however, may adversely affect the member's interest.

d. Rights of Creditors. A member has no direct ownership interest in the assets of an LLC that may be reached by his, her or its creditors. However, a member's creditors may reach his, her or its interest in the LLC. A judgment creditor of a member may apply to the court to charge the interest of a member or assignee 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 interest.

e. Dissolution. An LLC is dissolved and its affairs are to be wound up as specified in the Articles or operating agreement or generally upon a majority in interest of members, unless greater percentage of voting interests specified in Articles or operating agreement. But, on application by or for a manager or member, a court may decree dissolution of an LLC if it is not reasonably practicable to carry on the business in conformity with the Articles or operating agreement.

C. Quick Comparison of Features

1. Flow-Thru Tax. LLCs may be classified as partnerships for federal income tax purposes.

a. Advantage: None.

2. Limited Liability. The principal advantage of an LLC is the limitation on liability. In the case of a FLP, at least one partner (which may be a corporation or an LLC) must have unlimited personal liability. Further, the limited

partners may become liable for the debts of the partnership if they take part in the management of the business. These rules do not apply to participants in an LLC.

a. Advantage: LLC.

3. Accounting Methods. IRC Section 448(a) provides that C corporations, partnerships with C corporations as partners, or tax shelters must use the accrual method of accounting. The term "tax shelter" is defined as any enterprise other than a C corporation if at any time interests in the enterprise have been offered for sale in any offering required to be registered with any federal or state agency having authority to regulate the offering of securities for sale. The Regulations provide that an offering is required to be registered with a federal or state agency if, under federal or state law, failure to file a notice of exemption from registration would result in a violation of federal or state law.

In the case of a family LLC which is managed by all of its members, a securities qualification or registration will not be required if all members are actively engaged in the management. However, where an LLC is manager managed, it is necessary to file a notice of exemption for securities law purposes. Therefore, it is likely that a manager managed LLC would not be allowed to use the cash method of accounting. Similar restrictions apply to FLPs.

a. Advantage: Member-managed LLCs.

4. Debt Allocation/Basis. Where debt is not guaranteed by a member, it would seem that the LLC will be treated as having non-recourse debt under the Regulations used to determine outside basis (the basis of a partner in his or her partnership interest). (See Temporary Regulation Section 1.752-1T.) This would mean that all of the members would be eligible to claim a share of the debt for purposes of computing basis. Because all of the debt would be non-recourse, it would follow that the LLC will have a higher amount of non-recourse deductions than a FLP.

a. Advantage: Unclear. (Who do you represent?)

5. Passive Losses/Material Participation. It appears that only one of the special rules that apply to material participation by a limited partner for passive loss limitation purposes would apply in determining whether a member of an LLC materially participates in a passive activity. For example, under current Regulations, it would

appear that the member would have to participate in the activity for more than 500 hours, and would not be able to rely upon any of the other six methods for determining material participation. See Temporary Regulation Section 1.469-5T(e)(1) and (2).

a. Advantage: FLP.

6. Uncertainty in the Law. The laws relating to LLCs in the various states differ. For example, the Colorado LLC is treated as a partnership if the LLC qualifies as a partnership for federal tax purposes. In Florida, the LLCs are treated as C corporations for state tax purposes even if an LLC qualifies as a partnership for federal tax purposes.

In many of the LLC statutes, the entity terminates/ dissolves on the death of a member. The remaining members may continue the entity, but the damage may have been done and the IRS may be able to argue that the decedent's interest must be valued as a percentage of the underlying assets instead of using the discounted value of the LLC/entity.

a. Advantage: FLP.

7. Self-Employment Taxes. Self-employment tax is imposed on net earnings from self-employment. There are some exceptions to the net earnings from self-employment rule, namely, rental from real estate and the gain or loss from the sale of a capital asset.

In PLR 9423018, the Service held that, when a member was actively engaged in the professional business of an LLC, the member would not be treated as a limited partner under Section 1402(a)(13). Similarly, Proposed Regulation Section 1.1402(a)-(18) excludes from the ambit of this tax a member who is not a manager of a family LLC which could have been formed as a limited partnership. (Note that the definition of manager is any person who is vested with authority to make decisions. This appears broader than simply looking at whether the person has been designated as a manager in the Articles.)

In the case of an LLC, the test for self-employment tax is an all or nothing test. In the case of partnerships, if a person owns general and limited partner interests, only the earnings from the general partner interest are subject to this tax.

Under IRC Section 1402(a)(13), the income or loss of a limited partner other than guaranteed payments under IRC Section 707(c), is not earnings from self-employment.

a. Advantage: FLP.

8. Estate Planning/Valuation. FLPs may have slight estate-planning advantages over LLCs. Unless the members of an LLC provide otherwise in the operating agreement, each member has the right to withdraw from the LLC and become the holder of an economic interest. (Corp. Code § 17252.) A limited partner does not have the statutory right to withdraw from a FLP. (Corp. Code § 15663.) If an LLC member has the right to withdraw and receive fair value for his or her interest, the minority discount that applies when valuing limited partnership interests may not apply when valuing interests in an LLC. (See IRC § 2704(b).)

a. Advantage: FLP?

NOTE: The statutory provisions governing withdrawals in both LLCs and FLPs may be varied by agreement among the members/partners.

9. IRC Section 2704(b). Another technical estate tax advantage FLPs have over LLCs is contained in IRC §2704(b), which provides that a liquidation provision will be ignored where it is more restrictive than the limitations contained under "generally applicable" state law. This provision can be used by the IRS when determining the estate tax for a deceased general partner or LLC member.

If the IRS is successful in asserting that the partnership or LLC is dissolved on partner or member's death, the discount associated with the interest in the FLP or LLC could be substantially reduced. Consequently, in structuring family entities, measures should be taken to ensure the entity will continue after the death of a family member.

Under California law, a limited partnership will not dissolve when a general partner dies if there is another general partner in existence. While an LLC will not be dissolved upon a member's death, it can be dissolved by a vote of members holding a majority of the membership interests Since the FLP is more difficult to dissolve upon the death of a family member, as contrasted to an LLC, a FLP provides a greater likelihood of preserving any/all applicable valuation discounts, and avoiding the impact of IRC § 2704(b), in cases where one person owns a majority interest.

a. Advantage: FLP.