

Partnership Interests and Your Estate Plan

Consider the Issues To Avoid Harmful Consequences

If you have investments in partnerships — in conjunction with a profession or simply as an investment — you need to be aware of the estate planning issues these partnerships may create. The following information will help you review each of your partnership investments for which you need to draw up special provisions in your estate plan.

Professional Partnerships

Professional partnerships should have a partnership agreement to allocate profits and losses during the partners' lifetimes and provide a way to buy out a partner's interest. The buyout may include such items as accounts receivable, goodwill, and fixtures, furniture and equipment, and the purchase price may be a fixed dollar amount or based on a formula. These agreements are often funded with life insurance.

Investment Partnership

One type of investment partnership is the family investment partnership or family

limited partnership (FLP), in which you are the general partner and your children are limited partners. With an FLP, make sure you've planned for either someone, such as your spouse or a sibling, to act as successor general partner, or for the orderly dissolution of the partnership upon your death. If supervision of the interests is still needed or if the investment requires a single decision maker, you must provide for continuing management.

Another type of investment partnership is the "deal" partnership in which you own an interest in a building, shopping center, invention, restaurant or another joint venture. You may be a limited or general partner.

Partnerships Holding Liabilities

Partnerships may have liabilities attached. A professional partnership may have an underfunded pension plan or a professional liability claim lurking in the wings. In an investment partnership, one potential liability is a continuing capital call. When you made your

initial investment, you may have agreed to make additional investments at a stated time or at the general partner's discretion.

What are your estate's obligations when you die? If the capital call is indefinite — at the general partner's discretion — and you don't want your family or estate to be burdened with this investment after your death, consider leaving the partnership interest in its own trust. If the general partner can file a valid claim against your estate, you may not be able to do much, depending on the terms of the partnership agreement. If no claim is successfully filed, however, having the partnership interest in a separate trust may leave the general partner nowhere to go for the additional capital.

The general partner's only option may be to foreclose on the partnership interest. At this point, your beneficiaries and the trustee must decide whether the partnership interest is worth holding. If so, the trust can borrow funds to make the required investment of additional capital.

Phantom Income

Phantom income is taxable income that isn't accompanied by cash. If you've invested in a

rental real estate venture, either commercial or residential, the developer most likely took out a mortgage. As the partnership receives rental income, part or all of that income is typically used to pay the mortgage. Interest payments are deductible and offset income.

Payments allocated to mortgage principal reduce the amount owed but don't give you a deduction. You may get that payment back when you sell the real estate, but you currently have taxable income — from the partnership's rental income — and little or no cash because that income was used to make the mortgage payment rather than distributed to you. If you have such an investment, make sure that the beneficiary who receives it will have adequate liquid assets to pay income tax on the phantom income.

Valuation

How do you value a partnership interest? Unless you give your beneficiaries a proportion of all assets, you may find yourself determining a value for allocations and for federal estate tax. Because only a very limited market, if any, exists for closely held investments, only the general partners may be able to estimate a value, and they may estimate

the value based on book value (which has little or nothing to do with fair market value).

Therefore, consider specifically leaving the partnership interest to one heir and “making up” this bequest by allocating other property to the others based on what you feel the asset is worth. You have one big advantage over your executor in deciding such allocations: You have no duties of loyalty and fairness to anybody in how you leave your estate. If you give Susie the partnership investment, and Tommy and Lucy \$100,000 each to make up for the allocation to Susie, nobody can challenge your allocation.

If you tell the executor to give the partnership investment to Susie and to equalize the shares to Tommy and Lucy, the executor must come up with a fair valuation. Tommy and Lucy will argue for a higher valuation for the partnership investment, which will mean more taxes. Avoid putting your executor and beneficiaries in that position.

Audits

The 1960s, '70s and '80s were the days of tax shelter partnerships — investments where the transaction's tax characteristics were a significant motivation to invest. Most of

them were also sound economic investments, but a few had a questionable economic base. These were frequently audited, and taxpayers were required to consent to keeping taxable years open for many years.

Although the days of tax shelters are gone, a partnership interest may still expose you to the risk of an audit that is controlled by a general partner, not you. You may have to provide funds to your executor to meet obligations arising from the audit. Also, the government may try to foreclose on other assets or keep your estate in limbo if the audit determines that you owe additional tax based on your partnership interest. If you know of open years, consider preparing a cash needs analysis to determine your exposure. You may also want to buy life insurance to make cash available to pay for audits of open years.

Planning Ahead

Much of the advice here is general because so much depends on the unique characteristics of each partnership. But you should have an idea of where you expect each partnership to go when you die, regardless of whether that investment represents an asset or a liability.