

### Family Limited Partnerships

Family limited partnerships are simply limited partnerships owned and controlled by the members of a particular family. They are often used for the purpose of obtaining valuation discounts on gifts of limited partners' interests in them to family members, while one or more other family members who make the gifts retain control. However, because of a peculiarity of the Indiana statute, these desired discounts are not nearly so available for Indiana limited partnerships as they are for limited partnerships in most other states.

Indiana limited partnerships are governed by the Indiana Revised Uniform Limited Partnership Act, IC 23-16, adopted in 1988 ("IRULPA").

This statute significantly enhanced the protection of limited partners from personal liability for the obligations of the limited partnership in cases where they exercised some control over the limited partnership. Under the provisions of the previously applicable Uniform Limited Partnership Act of 1949, any kind of control by a limited partner could jeopardize that partner's protection from personal liability and expose that partner to the same liability as a general partner for all the limited partnership's obligations. By contrast, the 1988 statute limits the personal liability of a limited partner who "participates in the control of the business" to only those persons "who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." (IC 23-16-4-3(a)).

In addition, the next subsection of the statute lists a host of significant involvements of limited partners in the limited partnership's business that are not deemed to constitute "participation in the control" of that business such as to create possible personal liability. For example, among the many types of permissible involvement that a limited partner may have without "participating in control" within the meaning of the statute are:

“Being a contractor for, or an agent or employee of, the limited partnership or of a general partner, or being an officer, director, or shareholder of a general partner that is a corporation.” (IC 23-16-4-3(b)(1)).

Limited partners may also safely “consult with” or “advise” any general partner with respect to “any matter, including the business of the limited partnership.” (IC 23-16-4-(b)(2)).

The statute also lists many other such expressly permitted involvements of limited partners in their partnership’s affairs. (IC 23-16-4-3(b)(3) through (9)).

As an additional protection, the statute next provides that: “The enumeration of certain powers in subsection (b) does not mean, that the possession or exercise of any other powers by a limited partner constitutes participation by that limited partner in the control of the business of the limited partnership.” (IC 23-16-3(c)).

Thus, IRULPA nearly precludes the previous risk (under the former Uniform Limited Partnership Act of 1949) that a limited partner could inadvertently incur all the liabilities of a general partner by taking some active role in the limited partnership’s business. As long as that role fits within one of the enumerated permissible activities or otherwise falls short of “participation in control,” the limited partner may safely perform it. And, to repeat, even where a limited partner steps over the line and does “participate in control,” that limited partner’s resulting personal liability only extends to those persons who “transacted business with the limited partnership reasonably believing, based upon the limited partner’s conduct, that the limited partner was a general partner.” (IC 23-16-4-3(a)).

Another important protection introduced by IRULPA against the inadvertent assumption of personal liability by limited partners is the “cure” provision of IC 23-16-4-4 for persons who join a partnership erroneously but in good faith believing that they are doing so as limited partners. If within sixty (60) days after ascertaining the mistake, such a person who wishes to be a limited partner causes an appropriate certificate of limited partnership or certificate of amendment to be executed and filed, or such a person who wishes to withdraw from the partnership takes such action as is necessary to withdraw,

then the only personal liability of that person as a general partner is to third parties who have transacted business with the partnership prior to that event in the actual belief that the person who had mistakenly joined was a general partner, and acted in reasonable reliance upon that belief, and extended credit to the partnership in reasonable reliance on the credit of that person. *Id.*

With all this said, Indiana's limited partnership statute contains a serious flaw in terms of personal liability protection because it leaves the general partners of limited partnerships with unlimited personal liability. By contrast, the 2001 version of the Uniform Limited Partnership Act, which has been adopted in many states (including Illinois: *see*, 805 ILCS 215/404(c)), but not Indiana, provides for limited liability limited partnerships. These are, simply, limited partnerships that make an election to become limited liability limited partnerships, in which case even their general partners are not personally liable for such entities' obligations. Such an election - - not currently possible for an Indiana limited partnership, is of course an important protection not only for individual general partners, but also for corporate general partners. The latter are otherwise left exposed to judgment creditors' attacks on their owners on various "alter ego" and "piercing the corporate veil" theories.

Also, although the Indiana statute permits limited partnership agreements to impose strict restrictions on limited partners' rights of withdrawal and resulting cash liquidations of their interests, its default rule, i.e., the rule that applies in the absence of such special restrictions, is that unless the limited partnership agreement specifies other times of withdrawal or sets a definite time for the dissolution and dividing up of the limited partnership, limited partners may withdraw at any time upon six (6) months notice, (IC 23-16-7-3), and in that case, receive "the fair market value of the withdrawing partner's interest... as of the date of [the] withdrawal based upon the withdrawing partner's right to share in distributions from the limited partnership." (IC 23-16-7-4) (General partners also have the right to withdraw at any time upon written notice, but their resulting distributions may be offset by damages for any resulting breach of the partnership agreement.)

These provisions by themselves make the interests of partners in Indiana limited partnerships more vulnerable to attack by judgment creditors of those partners than they are under the Uniform Limited Partnership Act (2001), which provides that:

“A person does not have a right to receive [any] distribution on account of dissolution.” (805 ILCS 215/505).

These same provisions also make Indiana limited partnerships unsuitable vehicles for valuation-discounted gifts to family members. It would be difficult for any estate planner to justify any substantial valuation discount for intra-family gifts of limited partners' interests if the limited partners could at any time on six (6) months' notice withdraw and claim the full liquidation value of their interests. Moreover, because of the statutory default rule, any restrictions on those withdrawal rights imposed by the limited partnership agreement could be disregarded under I.R.C. Section 2704(b)(2) as “applicable restrictions.”

Indiana limited partnerships may be quite useful for other estate planning purposes such as facilitating a gifting program to younger family members while the donor retains such controls that the gifts would be brought back into his or her estate under I.R.C. Section 2036 if the gifts were made in trust. However, the above-mentioned statutory flaws concerning withdrawal and distribution rights and their negative effects on valuation discounts are so severe that Indiana limited partnerships can not be recommended as an appropriate vehicle if valuation discounts are an important client objective.

### Limited Liability Companies

Indiana's limited liability company statute, the “Indiana Business Flexibility Act,” was enacted in 1993. Surprisingly, even then, years before the I.R.S. adopted its “check-the-box” regulations in late 1996 making irrelevant the previous concerns that an LLC might exhibit too many “corporate” characteristics and too few “partnership” ones, the

Indiana LLC statute permitted single-member LLCs, manager-managed LLCs, and LLCs of perpetual duration. However, the “partnership” approach was partially carried over into the LLC statute, until its amendments in 1999, in that an LLC was automatically dissolved (unless otherwise provided in its operating agreement) whenever an “event of disassociation” occurred with respect to any member unless all the remaining members agreed to continue the business of the LLC within ninety (90) days afterward (IC 23-18-9-1). Dissolution without a “disassociation,” by consent of the members, also had to be unanimously approved.

This automatic dissolution upon the “dissociation” of any member was eliminated by the 1999 amendments for Indiana LLCs formed after June 30, 1999. IC 23-18-9-1.1.

This change was tracked by the statutory provision for distributions in liquidation of a member’s interest upon that member’s disassociation. For companies existing on or before June 30, 1999, the statute called for such distributions only upon the occurrence of an event of disassociation that did not cause a dissolution, whereas for subsequently formed companies, such distributions are required whenever there is a disassociation (unless the operating agreement provides otherwise). IC 23-18-5-5; IC 23-118-5-5.1.

The 1999 amendments also very usefully provided that no member of an LLC could withdraw from the company prior to its dissolution and winding up (unless the operating agreement provides otherwise). IC 23-18-6-6.1. This default rule was the complete opposite of the one that applied, and that continues to apply, for LLCs existing on or before June 30, 1999. In their case, any member could withdraw upon thirty (30) days’ written notice. IC 23-18-6-6.

As will be recalled from the preceding discussion of Indiana limited partnerships, this reversed default rule against voluntary withdrawals of LLC members makes Indiana LLCs much more attractive than Indiana limited partnerships as a vehicle for valuation-discounted intra-family gifts.<sup>1</sup>

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<sup>1</sup> Nevertheless, even with the removal of the problem of voluntary withdrawals and resulting required distributions in liquidation of a member’s interest removed, there are still so many other events of disassociation that do require such distributions that even an Indiana LLC can not be considered to be the ideal vehicle for valuation-discounted

Indiana LLCs also create somewhat more protection from personal liability for their actively participating members than Indiana limited partnerships do for limited partners who participate in control. As we have seen, IRULPA greatly limited the potential liability of limited partners who take an active role in their limited partnership's business, even to the extent of participating in control. However, the Business Flexibility Act took that liability limitation a step farther by providing that:

“A member, a manager, an agent, or an employee of a limited liability company is not personally liable for the debts, obligations, or liabilities of the limited liability company, whether arising in contract, tort, or otherwise, or for the acts or omissions of any other member, manager, agent, or employee of the limited liability company.” (IC 23-18-3-3(a)).

This additional advantage of LLCs over limited partnerships should not be exaggerated, for the next sentence of the same subsection provides that:

“A member, a manager, an agent, or an employee of a limited liability company may be personal liable for the person's own acts or omissions.” *Id.*

Clearly, though, a non-managing member of a manager-managed Indiana LLC has at least the same high degree of asset protection as a limited partner of an Indiana limited partnership who does not participate in its control; members of member-managed LLCs have broad protection against any sort of vicarious personal liability for the acts or

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gifting. Compare, again, the simple, superior default rule of the Uniform Limited Partnership Act (2001) that: “A person does not have a right to receive [any] distribution on account of disassociation.”

omissions of others; and so do even the managers of manager-managed LLCs - - in direct contrast to the general partners of limited partnerships.

A final advantage of Indiana LLCs over Indiana limited partnerships is their income tax flexibility. Although multi-member LLCs are ordinarily taxed as partnerships, single-member LLCs (and there can be no single-member partnerships) are ordinarily treated as non-entities, for federal income tax purposes, making them extremely useful in business tax planning. In addition, LLCs (but not limited partnerships) may elect to be taxed as if they were other sorts of entities - - S corporations or C corporations, for example.

These additional advantages of Indiana LLCs make them, in the author's view, definitely the superior of these two kinds of Indiana limited liability entities for estate planning purposes.

#### Other Limited Liability Entities

Indiana business corporations also provide a very high level of protection from personal liability for their shareholders who are not directors or officers. Shareholders have no right of "withdrawal" from such entities and so no right to have their interests liquidated except by the agreement of the corporation. Valuation discounts for intra-family gifts can, therefore, be as considerable as those for LLCs (which can themselves be the shareholders of corporations that are not S corporations).

The principal drawbacks of corporations for estate planning purposes are the lesser protections of corporate directors and officers from personal liability than the LLC statute provides for managers and members, the requirement that corporate directors and officers be individuals, and the generally less favorable income tax treatment of corporations than LLCs. Even S corporations, for example, can create major income tax liabilities for their shareholders if they ever liquidate or convert to LLCs. And, the qualification requirements for S corporation shareholders (for example, no limited liability entities except for S corporations that are the sole shareholders of other S corporations, and no trusts that are not grantor trusts, grantor-type trusts, or "Qualified

Small Business Trusts” taxed at the highest rate provided by the Internal Revenue Code), not to mention the one-class of stock requirement, make estate planning for the owners of S corporations considerably more problematical than for the owners of LLCs.

One additional type of limited liability entity should be mentioned here, the limited liability partnership. IC 23-4-1-15(2) provides that:

“A partner of a limited liability partnership is not personally liable, directly or indirectly, including by way of indemnification, contribution, or otherwise, for:

- (a) The debts, obligations, or liabilities of, or changeable to, the limited liability partnerships or other partner or partner, whether arising in tort, contract, or otherwise; or
- (b) The acts or omissions of any other partner;

solely by reason of being a partner, acting or failing to act as a partner, or participating as an employee, a contractor, or otherwise in the conduct of the business or activities of the limited liability partnership while the partnership is a limited liability partnership.”

For good measure, IC 23-4-1-15(6) adds that: “The laws of Indiana or another jurisdiction may not impose personal liability on a partner in a limited liability partnership. The only actions required of a limited liability partnership or of individual partners in such a partnership in order to avail themselves of the limited liability provisions of this chapter are those required by this chapter.”

In short, limited liability partnerships provide at least as great an amount of personal liability protection for their partners as LLCs do for their members - - and arguably even more than LLCs do for their managers. This feature makes them ideal for, among other things, professional practices.

However, strictly for estate planning purposes, they have the major drawback that any partner may withdraw at any time and demand a distribution in liquidation of his

interest. This feature, of course, virtually precludes the use of limited liability partnerships for valuation-discounted gifting. They are not indeed an estate-planning tool (although the required liquidation distributions for retiring partners can be a major estate asset). Instead, their great merit is the liability protection that they provide for partners, actively working together with all the collegiality and joint loyalty of general partners in a common endeavor. In that respect, they are one of the most important advances in Indiana limited liability law since the Indiana Business Flexibility Act for LLCs.