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WATCH OUT WHEN MAKING GIFTS OF LIMITED PARTNERSHIP INTERESTS

by Robert W. Wood

These days, one of the most popular tax and estate planning devices is the family limited partnership or family limited liability company. Although these forms of legal entities are nothing new (particularly the family limited partnership, which has been around for decades), practitioners are seeing them (and forming them) with increasing frequency. They are also taking more aggressive positions with valuation issues than perhaps was done until the last few years.

Not by coincidence, the Internal Revenue Service has recently leveled increasing criticism at the family limited partnership (and family limited liability company) device. More than anything else, the IRS is concerned at what the Service perceives as too aggressive an approach when it comes to valuation discounts. According to the Service, it should not be possible (within the confines of a limited partnership made up solely of family members) for an asset to be worth $1 million by itself, but have the same asset held in a limited partnership worth 40% or 50% less than it would have been outside the partnership. Minority discount is one thing, but let's not get piggish here!

Valuation issues aside, there is an often overlooked trap for family limited partnership formations and transfers. The assumption is always that interests in the family limited partnership can be given away to younger family members as a way of shifting value out of the older generation's estate and into younger family members' estates. Income shifting is also accomplished where the partnership actually produces cash flow (and even depreciation deductions). All of this hinges, of course, on the transfer to the younger family member being accomplished.

Most of it also hinges on the transfer qualifying for the gift tax annual exclusion. If it is a husband and wife making the transfers to their children, the annual exclusion per donee (for a joint gift made by husband and wife) can be $20,000 per donee per year. This $20,000 is typically used as a percentage of the value of the partnership. In this way, the gift tax annual exclusion can be computed. A married couple can make gifts of any number of limited partnership interests to different donees in any one tax year, as long as the value received by each donee does not exceed $20,000.

Depending on the number of prospective donees and the degree of aggressiveness of the valuation discount that is applied for minority limited partnership interests, substantial value can be transferred in several years. Indeed, substantial value can be transferred even in one tax year if there are enough donees. I recently had a case involving 28 grandchildren, all of whom received limited partnership interests.

Annual Gift Tax Exclusion?

It should not be overlooked, however, that for all of this annual exclusion tax planning to work the limited partnership interest transferred must actually be present interest. Unfortunately, there is at least one cloud on the horizon that practitioners ought to watch out for. That is Technical Advice Memorandum 9751003. This was a fairly

typical fact pattern, but with a couple of glitches that are important to note.

The taxpayer in this tech advice memo claimed annual exclusion gifts for transfers of limited partnership interests that she made to 35 family members and trusts for the benefit of minor family members. The taxpayer transferred a 94.77% interest in a building to the limited partnership and received a 90.6% limited partnership interest. She transferred the remaining 5.23% interest in the building to an S corporation of which she was the sole shareholder. The S corporation transferred its interest in the building to the limited partnership, and received a 5% general partnership interest. Thus, the arrangement was a fairly typical list of individual (and trust) family members as limited partners, and an S corporation general partner.

Eleven of the family members (who owned another building) transferred that building to the limited partnership, too. Plus, the taxpayer and the S corporation later made additional capital contributions to the limited partnership so that additional property could be purchased. After this, more gifts of limited partnership interests were made.

All of this may sound fairly typical, except that the limited partnership agreement itself was somewhat unusual. When the smoke cleared in these various intra-family assignments and transfers, family members owned a 95% limited partnership interest, and the S corporation owned a 5% general partnership interest. However, the limited partnership agreement allowed the general partner complete discretion to retain funds within the partnership for "any reason whatsoever." It also imposed significant restrictions on the ability of limited partners to transfer or assign their interests or to withdraw from the partnership.

Under these circumstances, the IRS ruled that the limited partnership interests were not gifts of a present interest in property, because the donees did not have the right to a substantial present economic benefit. The IRS separated the gift into income and corpus. As to the income, the IRS ruled that the right of the general partner to retain funds for "any reason whatsoever" was extraordinary and was outside the scope of typical business purpose restrictions.

According to the IRS, it was uncertain at the time the gifts were made whether any income would be distributed to the limited partners. Because of the absence of an ascertainable income flow, immediate enjoyment of any portion of the income was prevented. Therefore, the IRS found that the income component was not a present interest.

The IRS also ruled that the prohibitions of transfer or assignment of the limited partnership interests, and the restrictions on withdrawal, all contained in the partnership agreement, caused the actual limited partnership interests themselves (what the IRS referred to as corpus) to lack the tangible and immediate economic benefit required for a present interest. See I.R.C. §2503(b). While the limited partners could join with other partners to liquidate the partnership, the IRS stated that an economic right requiring joint action with others was a contingent right and was regarded as a future interest rather than a present economic right.

Hurtful Bottom Line

The conclusion of Technical Advice Memorandum 9751003 was that the gifts of the

limited partnership interests did not qualify for the gift tax annual exclusion. This was a highly negative result, and could easily be presented by verifying that the limited partnership agreement does not contain the offending provisions. While it is perfectly acceptable to have the general partner have the right to maintain reserves as judged necessary by the general partner, there should be a list of items for which reserves may be maintained. Putting into a family limited partnership agreement that the general partner can fail to make any distributions and can simply sit on the money "for any reason whatsoever" seems imprudent.

The transferability question is somewhat more difficult to address, since most family limited partnerships and the families that control them do not wish to have transfers occurring at all. However, an absolute prohibition on any assignment, and unanimous action to dissolve, is certainly not needed.

***Be Careful When Making Gifts of Limited Partnership Interests*, Vol. 16, No. 8, Real Estate Tax Digest (August 1998).**