FAMILY LIMITED PARTNERSHIPS

WRONG WORDING KILLS EXCLUSION FOR LIMITED PARTNERSHIP INTEREST GIFTS

An analysis of recent TAMs that reject transfer tax savings for some family limited partnership arrangements offers insights into what provisions the IRS should find acceptable.

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The family limited partnership (FLP) is an increasingly popular vehicle for transferring family wealth in a manner that attempts to substantially leverage the lifetime transfer tax exemption, the generation-skipping transfer tax exemption, and the annual per-donee gift tax exclusion by discounting the valuation of the underlying assets being given as gifts. [1] The leverage is based on valuation discount factors.

FLP mechanics

The family limited partnership gift-giving device works as follows: A taxpayer holding substantial assets earmarked for transfer to children or grandchildren organizes a limited partnership in which he or she is both the general partner and a limited partner. The various family members who are to be the gift recipients are made limited partners of the partnership. The taxpayer transfers the assets to the partnership as a capital contribution with respect to his or her limited partnership interest. This is a tax-free transfer, with carryover of basis. The capital contributions with respect to the general partnership interest and all of the other limited partnership interests are nominal cash amounts (e.g., $100 each).

This sets the stage for a program of giving portions of the taxpayer's limited partnership interest to the other limited partners, using the per-donee annual exclusion, the estate tax applicable exemption amount, or the generation-skipping transfer tax exemption. The key element here is the valuation of the limited partnership interests transferred.

While appropriate fair market valuation standards must be applied, clearly a given percentage interest in the partnership entity in the form of a limited partnership interest is worth less than the same percentage interest held directly in the underlying net assets. This is a result of a combination of two discounting factors:

(1) *Absence of control.* The limited partnership interest has no voice in the management of the assets, nor the ability to effect their sale and realization of cash. This is because in a typical limited partnership, only the general partner or partners have decision-making authority, and the limited partners hold only passive economic interests.

(2) *Lack of marketability.* There are restrictions on the transferability of the interest.

The combination of these two factors results in a substantial limited partnership valuation discount.

PARTNERSHIP PLUSES

Establishing a family partnership eases the task of dividing a large asset among several beneficiaries and further splitting the gift-giving process by spreading gifts over several years. The donor can choose what value gift to give (e.g., $10,000 per year per recipient to correspond with the annual gift tax exclusion) and then determine what percentage partnership interest corresponds to that value.

Because a partnership is a pass-through entity, items of income and deductions retain their character as they pass through to partners. Using a limited partnership, rather than a general partnership, has these advantages:

- Only the general partner (i.e., the donor) is personally liable for partnership debts.
- As the only general partner, the donor retains managerial control over the partnership operations.
- Unlike the restrictions that are commonly placed on limited partner withdrawals, with a general partnership, each partner can withdraw and usually compel the partnership to be dissolved and distribute an allocable share of the partnership property. Besides causing potential continuity and management problems should there be dissention among partners, this right reduces the lack-of-marketability discount factor when the gifts are first made.

IRS position

Until 1997, the IRS had taken a rather benign attitude toward FLPs, generally accepting the legitimacy of the partnership entity, without much questioning of its business purpose. In fact, a series of rulings in the early 1990s eliminated several of the potential roadblocks to successful use of FLPs as an estate planning vehicle.

Sham transaction theory. In 1997, the Service issued a series of technical advice memoranda in which the FLP gift-giving device was rejected. All of the cases involved rather egregious factual situations, and it is understandable that the Service had to begin stepping in and taking a stand to prevent abuse of an increasingly popular planning technique. Most of these TAMs involved death-bed transfers of assets to newly-formed limited partnerships, followed at once by gifts of limited partnership interests, all immediately prior to the transferor's death. The Service effectively applied "sham transaction" theory, concluding that the successive steps amounted, in substance, to integrated testamentary transfers; therefore, the intermediate transfers to the partnerships should be ignored for tax purposes.

Valuation discount denied. Also in these 1997 TAMs, the IRS introduced an alternative attack on the FLP discounting technique: **Section 2703** , which contains the language "the value of any property shall be determined without regard to ... any restriction on the right to sell or use such property." While it is unlikely that the enactment of **Section 2703** was aimed at FLPs, the language may be applied to bar the lack-of-marketability discount in valuing gifts of limited partnership interests. This position has not yet been tested in litigation. Even if **Section 2703** is held applicable, however, it would preclude only one of the two discounting factors; it would not bar discounting based on the minority-interest/absence-of-control factor, the other key discounting element.

No annual exclusion. One of the important FLP gift-giving techniques is the leveraging of the $10,000 per-donee annual gift tax exclusion. Thus, each of the children and grandchildren who might otherwise be given $10,000 ($20,000 if the transferor's spouse joins in the gifts) in cash or other assets each year, free of gift tax, would instead become limited partners in an FLP and receive their gifts in the form of limited partnership interests at valuations discounted to the $10,000/$20,000 exclusion amount.

For a gift to qualify for the annual exclusion, the interest given may not be a "future interest in property." **2** In 1991, TAM 9131006 raised the issue of whether a limited partnership interest amounted to a "future interest." The IRS held that a limited partner's being devoid of control of the underlying assets-with sole control retained by the transferor (in the capacity of general partner)-does *not* cause the transfer to be a gift of a future interest.

Moreover, the fact that the transferor of the limited partnership interests is also the general partner who retains complete control over the underlying assets does not cause the transferred interests to be brought back into the transferor's gross estate under the "strings-attached" provisions of **Section 2036** or **2038** . These favorable conclusions were reinforced in subsequent private letter rulings, **3** and the future-interest question was thought to have been put to rest.

Back to the future-interest issue

In a recent TAM, the Service surprised practitioners by reopening the future-interest issue, apparently as part of an effort to more aggressively rein in FLPs as a valuation discounting device. In **TAM 9751003** the Service concluded that the gifts of limited partnership interests did not qualify for the annual exclusion, because they amounted to gifts of future interests. This seems to directly contradict the conclusion of the 1991 TAM discussed above. None of the earlier TAMs are referred to in the discussion preceding the holding. Nonetheless, a careful examination of the facts in **TAM 9751003** indicates that the partnership agreement in that case was drafted in such a manner that the IRS was able to conclude that the limited partnership interests had no current value as a practical matter, and therefore, they should be viewed as future interests under **Section 2503** .

Partnership provisions. The Service referred to, and quoted from, several specific provisions of the partnership agreement in support of this conclusion:

1.*Distributions of income.* The general partner had sole discretionary authority over distributions of funds to the partners. "[T]he general partner shall have complete discretion to retain funds within the partnership for future partnership expenditures or *for any reason whatsoever.*" [Emphasis supplied.]

2.*Transfers of interests.* "[N]o Limited Partner's interest in the Partnership shall be assigned, mortgaged, pledged, subjected to a security interest or otherwise encumbered, in whole or in part, and any attempt [to do so] shall be void ab initio." This restriction, however, does not apply to transfers of limited partnership interests held by the general partner.

3.*Substitution of limited partners.* A limited partner may assign his or her interest with the permission of the general partner, but the assignee acquires only the assignor's financial interest and does not become a substituted limited partner unless approval is granted by the general partner, plus at least 50% of the partnership interests held by the other partners. If neither the original general partner nor the general partner's estate holds any limited partnership interest, the substitution must be approved by at least 67% of the partnership interests.

Relying on these highly restrictive provisions, the IRS concluded that "although title [to the limited partnership interests given as gifts] vested in the donees, the limited partnership interests lacked the tangible and immediate economic benefit required under section 2503(b) for a present interest in property.... [T]he gifts failed to confer on the donees the substantial present economic enjoyment required ... for a present interest."

Perhaps the most damaging of the partnership provisions cited in the TAM is the one concerning the absolute discretion of the general partner over distributions to partners, and his discretion to retain funds within the partnership for any reason whatsoever. The Service relied heavily on this provision (quoting in its discussion the phrases "complete discretion" and " *for any reason whatsoever*" (emphasis supplied at source).

General partner's unfettered authority. The thrust of the Service's reasoning here is that, because the general partner had absolute unfettered authority to never make a distribution to the limited partners, the interests of the limited partners had no current value; they could not count on receiving any current return with respect to their interests. Moreover, they were effectively prevented from realizing anything from selling or otherwise assigning their interests since there was an absolute prohibition on such transfers without the permission of the general partner. Even if such an assignment were permitted by the general partner, the assignee could not become a substituted partner without the approval of a "super-majority" of the partners. In net effect, without the action or approval of the general partner, the limited partnership interests could produce nothing of immediate value to the limited partners until the specified date for termination of the partnership in the year 2022.

While it is not uncommon for a limited partnership agreement to provide for current cash distributions only in the discretion of the general partners, a principle of partnership law is that general partners have a fiduciary obligation with respect to their limited partners, and this would extend to managing the partnership's cash resources, including distribution decisions, with due regard to the interests of the limited partners. This fiduciary obligation does not necessarily require regular distributions of current cash flow, but it does require the general partners to act prudently-not arbitrarily.

The IRS relied on this fiduciary obligation in reaching its conclusion in the earlier TAMs that the limited partnership interests were present interests, even though the general partner had sole discretion over distributions. Although the 1997 TAM does not refer to earlier TAMs by way of contrast, it relies on the language that cash can be retained by the general partner in the partnership for any reason whatsoever as "extraordinary and outside the scope of a business purpose restriction." This language is said to effectively obviate the fiduciary duty ordinarily imposed on a general partner.

Practical impact of TAM

The holding in **TAM 9751003** might appear at first blush to derail a major element of the leveraging potential of FLPs, by making them ineligible for the gift tax annual exclusion. A thorough reading of the facts and IRS analysis, however, indicates that this was a case of a partnership agreement with untypical, extremely aggressive provisions, probably in an overzealous attempt to diminish the value of the limited partnership interests for gift tax purposes.

Limit limitations. The tendency to draft a family limited partnership agreement with a view toward limiting the value elements of the limited partnership interests is understandable, given the objective of maximizing the discount in valuation for transfer tax purposes. Even so, this ruling illustrates that some measure of restraint is necessary, lest the interests are so stripped of *current* value as to be only future interests under **Section 2503(b)** .

The adverse holding in **TAM 9751003** seems avoidable by simply using the reasonable limitations contained in typical limited partnership forms, which generally evolved to comply with the Uniform Limited Partnership Act (applicable in most states). Generally, these partnership forms place at least some limitations on the transferability of partnership interests. It stands to reason that a group of partners would want the right to approve or disapprove the admission of an intended transferee as a substituted partner.

This limitation on free transferability has been one of the factors justifying the valuation discounting of transferred limited partnership interests-"marketability" discount (although use of this discount element may be subject to challenge under **Section 2703** , as discussed above). **TAM 9751003** offers a warning that this limitation should be drafted with reasonable restraint.

Common restrictions. Forms commonly used by practitioners restrict free transferability, but they may impose a right of first refusal, so the restriction is not an absolute bar to a disposition of the interest. Another common restriction is to permit assignment of the economic benefits of a limited partnership interest (e.g., the right to receive the partner's cash flow distributions), but require certain approvals before the assignee can become a substituted limited partner with the additional right attendant to such status.

Of course, the most damaging provision in the partnership agreement in **TAM 9751003** was the language permitting the general partner to retain funds within the partnership (i.e., not make distributions to limited partners) "for any reason whatsoever." The Service deemed such language effectively to override the general partner's fiduciary obligation to the limited partners. This fiduciary obligation was the underpinning of the earlier rulings that held limited partnership interests were not future interests. Thus, to diminish the potential valuation of limited partnership interests, care must be taken to avoid giving the general partner such unfettered discretionary power as could be deemed to override the general fiduciary obligation.

Of course, current cash distributions to limited partners are the most obvious indicator that the limited partnership interests are not just future interest. This does not necessarily mean that the partnership agreement must mandate that current operating cash flow be distributed regularly. Distributions can be left to the discretion of the general partner, who must exercise that discretion based on reasonable business judgment with due regard to the financial interests of the limited partners. Language giving the general partner authority to act or not act "for any reason whatsoever," or similar totally unfettered authority must be avoided.

Conclusion

As the FLP transfer tax valuation discounting technique has gained popularity with estate planners, so has it gained increasing IRS scrutiny. The series of adverse TAMs, which commenced in 1997, may be expected to continue. Eventual litigation seems likely. **TAM 9751003** represents a collateral attack on FLPs, through the future-interest language of **Section 2503(b)** . This TAM does not purport to deny the annual gift tax exclusion for all gifts of limited partnership interests, but rather, it should be taken as a lesson for those practitioners involved in the drafting of FLP agreements.

The TAM teaches that drafting with the objective of diminishing the value of limited partnership interests to the greatest extent possible, in order to maximize transfer tax valuation discounts, must be balanced with the need to avoid making them effectively only future interests. A key element in this balancing is the avoidance of absolute unfettered discretion in the general partner or any language that might be interpreted as overriding the general partner's fiduciary obligation to the limited partners.

1
See Toth, "The Family Limited Partnership Under Siege," 59 TA 346 (December 1997).

2
Section 2503(b) .

3
Ltr. Ruls. 9310039 , 9332006 and 9415007.