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RECENT DEVELOPMENTS IN FAMILY LIMITED PARTNERSHIPS

— by Neil E. Harl[*]

Several recent private letter rulings have jolted limited partnerships in general[1] and family limited partnerships in particular. Although the limited partnership and other types of entities with similar features continue to be useful business planning tools, these developments will likely curb some of the more aggressive applications of the limited partnership concept. Care is warranted in drafting and implementing business plans involving all types of pass-through entities where the rulings could be applied. The limited partnership is not completely unique in these respects.

No gift tax annual exclusion

A private letter ruling published in late 1997[2] disallowed a federal gift tax annual exclusion for gifts of interests in a family limited partnership.

In the facts of the ruling, on December 30, 1991, a 71-year old donor who owned two industrial buildings gifted a one-eleventh interest in Building 2 to each of 11 family members. Two days later, the 11 family members reallocated their interests in Building 2 so that each of the four "family units," representing the donor's four siblings, owned a one-quarter interest. In September of 1992, the donor set up an S corporation and, a few days later, created seven trusts for the benefit of seven grandnieces and grandnephews who were minors. Later, in 1992, the donor formed a limited partnership. On December 31, 1992, several transfers were made—

- The donor transferred a 94.77 percent interest in Building 1 to the limited partnership and received a 90.6 percent limited partnership interest. The remaining 5.23 percent interest in Building 1 was transferred to the S corporation which in turn transferred the interest to the limited partnership for a 5 percent general partnership interest.
- The 11 family members who owned Building 2 transferred their 100 percent interest in the building to the limited partnership for a 4.4 percent limited partnership interest.
- The donor gifted a 29 percent limited partnership interest to 35 family members and trusts for those who were minors."

The following year, the donor gifted a 42 percent limited partnership interest to the same 35 family members and trusts (for those who were minors). In 1994, the donor gave her remaining limited partnership interests to family members. At that point,

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the donor's family owned a 95 percent limited partnership interest and the donor's wholly-owned S corporation owned a 5 percent general partnership interest.

The limited partnership agreement contained some unusual provisions. Income was distributable to the limited partners in the "sole discretion" of the general partner. Funds could be retained by the general partner within the limited partnership for future partnership expenditures. The general partner was empowered to retain funds "for any other reason whatsoever." The donees could not transfer or assign their interests nor could they withdraw from the partnership or receive a return of capital contributions until the year 2022.

The ruling states that the "provision for the general partner's retention of income 'for any reason whatsoever' is extraordinary and outside the scope of a business purpose restriction."[3] The ruling notes that such a provision "obviates the fiduciary duty ordinarily imposed upon a general partner, and clothes the general partner with the authority to withhold income for reasons unrelated to the conduct of the partnership."[4] Therefore, it was uncertain whether, at the time of the gifts, any income would be distributed to the limited partners.[5] Accordingly, the gift was not a present interest and the federal gift tax annual exclusion was unavailable.[6] The ruling explains that the limited partnership interest lacked the "tangible and immediate economic benefit required…for a present interest in property."[7]

No discounts allowed

Discounts for non-marketability and for a minority interest have been allowed for limited partnerships[8] although a 1990 Tax Court case disallowed a valuation discount where the transaction was entered into for the sole purpose of reducing federal estate tax.[9] Similarly, a 1997 Tax Court case rejected discounts as producing an unrealistically low value.[10]

In the first private letter ruling issued in 1997,[11] a family limited partnership formed two days before death was disregarded by IRS for valuation purposes. As the ruling noted, the only purpose for the partnership was to depress values of partnership assets passing through the estate to the children.

In a second ruling in 1997, a limited partnership formed pursuant to a power of attorney two months before a decedent's death was disregarded by IRS for federal estate tax valuation purposes.[12] In that ruling, the transfer of the decedent's two residences and personal property in exchange for a 98 percent limited partnership interest followed by transfer of the partnership interest to a revocable trust for distribution to a son was treated as a single testamentary transaction. IRS believed that nothing of substance was intended by the partnership arrangement.

The third ruling, about a week later,[13] involved a partnership formed from assets held in a revocable inter vivos trust two months before death when the taxpayer was incompetent. The partnership was disregarded for property valuation purposes as serving no business purpose and was not a bona fide, arm's length business arrangement.

In the fourth ruling, $400,000 of farmland was exchanged for a 99 percent limited partnership interest.[14] The attempt, 54 days later, to value the partnership interest at a 40 percent discount for federal estate tax purposes was unsuccessful. As the ruling notes, the Internal Revenue Service evaluates such transactions in light of whether the arrangement—(1) was a device to transfer property to a family member for less than adequate consideration and (2) was not the result of arm's length negotiations having a valid business purpose.[15] Indeed, if the only purpos behind the formation of a family limited partnership is to depress asset values, with nothing of substance changed as a result, the restrictions imposed by the partnership agreement are likely to be disregarded.

In conclusion

A family limited partnership entered into for substantial business reasons with traditional provisions as to the rights of limited partners is unlikely to be challenged. But IRS has served notice that attempts to push the concept into tax avoidance or beyond will be resisted.

FOOTNOTES

1 See generally 5 Harl, *Agricultural Law* Ch. 61 (1997); Harl, *Agricultural Law Manual* § 7.04 (1997).

2 Ltr. Rul. 9751003, Aug. 28, 1997.

3 *Id.*

4 *Id.*

5 *Id.*

6 I.R.C. § 2503(b).

7 Ltr. Rul. 9751003, Aug. 28, 1997. See, e.g., Berzon v. Comm'r, 534 F.2d 528 (2d Cir. 1976).

8 See Estate of Watts v. Comm'r, T.C. Memo. 1985-595 (35 percent discount of 15 percent partnership interest for federal estate tax purposes).

9 Estate of Murphy v. Comm'r, T.C. Memo. 1990-472.

10 Estate of Lehmann v. Comm'r, T.C. Memo. 1997-392.

11 Ltr. Rul. 9719006, Jan. 14, 1997.

12 Ltr. Rul. 9723009, Feb. 24, 1997.

13 Ltr. Rul. 9725002, March 3, 1997.

14 Ltr. Rul. 9730004, April 3, 1997.

15 *Id.*