



**Agricultural Law Press**

Publisher/Editor

Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

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**Issue Contents**

**Bankruptcy**

General

Exemptions

Refund **182**

Federal tax

Discharge **182**

**Debtor and Creditor**

Fiduciary duty **183**

**Federal Agricultural Programs**

Agricultural Management Assistance

Program **183**

Beans **183**

Confined animal feeding operations **183**

Crop insurance **183**

**Federal Estate and Gift Taxation**

Disclaimers **183**

Power of appointment **183**

**Federal Income Taxation**

Biofuels **184**

Charitable deductions **184**

Depreciation **184**

Disaster area bonds **184**

Disaster losses **184**

Employee benefits **184**

Innocent spouse **184**

Mileage deduction **185**

Returns **185**

Sale of capital assets **185**

Safe harbor interest rates

December 2008 **185**

S corporations

Compensation for shareholders **185**

Gross income **186**

Social security taxes **186**

**Labor**

Agricultural employees **186**

**Secured Transactions**

Good faith purchaser **186**

**State Taxation**

Agricultural use **187**

**Transportation**

Closure of road **187**

Farm equipment **187**

**Workers' Compensation**

Agricultural employee **187**

**Zoning**

County ordinance **187**

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## Indirect Gifts on Formation of a Family Limited Partnership

-by Neil E. Harl\*

Although family limited partnerships are basically a variant (in form more than substance) of the limited partnership,<sup>1</sup> and are generally subject to taxation under the Subchapter K of the Internal Revenue Code as partnerships,<sup>2</sup> family limited partnerships have acquired a reputation stemming from a perception of tax avoidance and tax sheltering as well as hurried and often careless planning and formation rather than a reputation as a business organizational structure driven by genuine business-related motives and careful planning. Accordingly, the level of scrutiny by the Internal Revenue Service has appeared to be elevated simply by their name and nature.

Recent cases dealing with the question of whether indirect gifts to the partners in a family limited partnership may flow from formation of the entity strengthen those observations.<sup>3</sup>

### Indirect gifts

A direct gift, of course, is subject to federal gift tax.<sup>4</sup> The Internal Revenue Code refers to “. . . the transfer of property by gift. . .”<sup>5</sup> The regulations go on to state that the gift tax applies “. . . whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.”<sup>6</sup> In defining “indirectly made,” the regulations state that “. . . all transactions whereby property or property rights or interests are gratuitously passed or conferred upon another, regardless of the means or device employed, constitute gifts subject to tax.”<sup>7</sup> The regulations contain an example of where a transfer of property by a corporation to a shareholder is considered to be a gift from the other shareholders of the corporation. Similarly, a transfer to a corporation generally represents gifts to each of the corporate shareholders.<sup>8</sup>

Thus, it is well established that a transfer of assets to a corporation in exchange for a promissory note for less than the fair market value of the assets transferred is a gift to the shareholders and the gift is a future interest, not eligible for the annual exclusion.<sup>9</sup> Similarly, the transfer of bonds to a limited partnership was an indirect gift to the taxpayer's two children who were partners in the limited partnership.<sup>10</sup>

### Indirect gifts on formation of family limited partnership

So what's the problem with indirect gifts in a family partnership? The problem, in short, is in not completing the transfers to the FLP before making transfers of partnership shares. In *Shepherd v. Commissioner*,<sup>11</sup> the transfer of leased timberland and bank stock to a general family partnership in which the donor held a 50 percent interest (and each son held a 25

\* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

percent interest) constituted indirect gifts to the sons of the undivided 25 percent interests in the land. The donor's transfer of the timberland did not represent gifts of minority partnership interests to the sons because – (1) the donor initially reported the transfer as a gift of land on the federal gift tax return; (2) the formation of the partnership preceded the completion of the donor's transfer to the partnership, with the sons receiving their interest in the timberland by virtue of their pre-existing partnership interests and (3) the tax effect of the transaction was based, not on the donor's intent, but upon the actual sequence of events. The claimed 33.5 percent discount (which was agreed to in a pre-trial stipulation) was denied in favor of a 15 percent discount for undivided fractional ownership interests of the land. Thus, as the court stated, "instead of completing a gift of land to a pre-existing partnership in which the sons were not partners and then establishing the partnership interest of his sons which would result in a gift of a partnership interest, Shepherd created a partnership in which his sons held established shares and then gave the partnership a taxable gift of land (making it an indirect gift of the land to his sons)."<sup>12</sup>

In the case of *Senda v. Commissioner*,<sup>13</sup> the partnership records were non-existent or unreliable with some prepared several months after the transfers of partnership interests. As the Eighth Circuit Court of Appeals stated, ". . . a contribution of stock *after* the transfer of partnership interests is an indirect gift to the partners. . . ." <sup>14</sup> The Commissioner valued the gifts at the full undiscounted value while the taxpayers valued the gift with a discount for lack of marketability and minority interest status.<sup>15</sup>

By contrast, in *Holman, Jr. v. Commissioner*,<sup>16</sup> the Tax Court held that transfers of limited partnership interests to a trust and a custodial account were not indirect gifts because the taxpayers did not transfer the shares to the trust and the custodial account before making the contributions to the limited partnership. Six days separated the contribution to the limited partnership and the gifts of the limited partnership shares.<sup>17</sup> The gifts could be valued as partnership interests with discounts allowed for lack of control and lack of marketability.<sup>18</sup>

## ENDNOTES

<sup>1</sup> Uniform Limited Partnership Act (U.L.P.A.) § 1 (1916); Revised Uniform Limited Partnership Act (R.U.L.P.A.) § 1 (1976). See Harl, *Agricultural Law* Ch. 61 (2008); Harl, *Agricultural Law Manual* § 7.04 (2008).

<sup>2</sup> I.R.C. §§ 701-776. See Harl, *Farm Income Tax Manual* Ch. 6 (2008).

<sup>3</sup> *Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002); *Senda v. Comm'r*, T.C. Memo. 2004-160, *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *Holman, Jr. v. Comm'r*, 130 T.C. No. 12 (2008).

<sup>4</sup> I.R.C. § 2501(a)(1).

<sup>5</sup> *Id.*

<sup>6</sup> Treas. Reg. § 25.2511-1(a).

<sup>7</sup> Treas. Reg. § 25.2511-1(c).

<sup>8</sup> Treas. Reg. § 25.2511-1(h)(1).

<sup>9</sup> See, e.g., *Hollingsworth v. Comm'r*, 86 T.C. 91 (1986). See *Estate of Stinson v. United States*, 214 F.3d 846 (7th Cir. 2000) (debt forgiveness to corporation was future interest gift to shareholders).

<sup>10</sup> Ltr. Rul. 200212006, Nov. 20, 2001.

<sup>11</sup> 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

<sup>12</sup> *Id.*

<sup>13</sup> T.C. Memo. 2004-160, *aff'd*, 433 F.3d 1044 (8th Cir. 2006).

<sup>14</sup> *Id.* (italic emphasis added).

<sup>15</sup> *Id.*

<sup>16</sup> 130 T.C. No. 12 (2008).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

# CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

## BANKRUPTCY

### GENERAL

#### EXEMPTIONS

**REFUND.** The debtor filed for Chapter 7 on March 31, 2008, and claimed a state wage exemption for 2008 taxes which had been withheld prior to the filing of bankruptcy but which could be refunded after filing the 2008 return. The court held that the

Montana Code § 25-13-614 exemption for wages did not include federal tax refunds for excess taxes. *In re Sebastian*, 2008-2 U.S. Tax Cas. (CCH) ¶ 50,642 (Bankr. D. Mont. 2008).

### FEDERAL TAX

**DISCHARGE.** The IRS audited the debtor's 1982 tax return and the debtor signed a Form 872-A, Special Consent to Extend the Time to Assess Tax, as to the 1982 return. No further action was taken by the IRS or debtor on the 1982 tax return before the debtor filed for Chapter 7 in 1992. No claim was filed for the 1982 taxes and the debtor received a discharge of all filed claims, including taxes for