

FAMILY LIMITED PARTNERSHIPS

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Gifts of Family Limited Partnership Interests Did Not Qualify for Annual Exclusion, Rules IRS

Relying on language contained in the partnership agreement, TAM 9751003 recently concluded that gifts of limited partnership interests were not transfers of present interests and, therefore, did not qualify for the \$10,000 gift tax annual exclusion. In the TAM, the donor (Mary), a widow with no children, owned two pieces of real estate (Building 1 and Building 2). In December 1991, Mary made a gift of Building 2 to 11 family members who then reallocated their interests in the building into four equal parts, divided among four family groups representing Mary's four siblings.

In the fall of 1992, Mary created an S corporation (Scorp), to which she transferred \$9,800 in cash. She was the sole shareholder of Scorp.

In December 1992, Mary formed a family limited partnership (FLP). She transferred a 94.77% interest in Building 1 to

the FLP in exchange for a 90.6% limited partnership interest. She transferred the balance of her interest in Building 1 to Scorp, which in turn transferred that interest to the FLP in exchange for a 5% general partner interest. The family members who owned Building 2 transferred Building 2 to the FLP in exchange for a 4.4% limited partnership interest.

Also in December 1992, Mary transferred a 29% limited partnership interest in the FLP to 35 family members (including trusts for minors). In 1993, Mary transferred a 42% limited partnership interest to the same 35 family members. In 1994, Mary transferred the balance of her limited partnership interest to the 35 family members, who then owned a 95% limited partnership interest in the FLP, leaving Scorp holding a 5% percent general partner interest. Because Mary owned Scorp, she controlled the FLP.

Present interest gifts

The issue in the TAM was whether any of the annual gifts to the 35 family members qualified for the \$10,000 gift tax annual exclusion. To qualify for the exclusion, the gifts must be gifts of a present interest. Under Reg. 25.2503-3(b), a present interest is an unrestricted right to the imme-

diante use, possession, or enjoyment of property.

Until the decision in TAM 9751003, the general rule was that so long as gifts of limited partnership interests were outright, they qualified for the annual exclusion. In *Byrum*,¹ a decedent transferred stock in a closely held corporation to an irrevocable trust, but retained the right to vote the transferred stock and to veto any sale or disposition of the stock by the trustee. The Supreme Court there held that the decedent had a fiduciary duty to promote the interests of the corporation and could not exercise his voting rights for personal gain at the expense of the minority shareholders.

After *Byrum*, Section 2036 was amended to provide that the retention of voting rights in a controlled corporation will cause the transferred stock to be included in the transferor's gross estate.

In *Ltr. Rul.* 9415007, a transferor made gifts of limited partnership interests. The IRS determined that the management powers retained by the transferor as general partner, including control over distributions, must be exercised by the transferor in a fiduciary capacity and did not transform the gifts into gifts of future interests. Consequently, the gifts qualified as present interest

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gifts eligible for the annual exclusion.

Provisions of the partnership agreement

In TAM 9751003, the IRS relied on the following provisions in the partnership agreement in holding that the transfers did not qualify for the annual exclusion:

1. *The general partner could retain funds within the FLP "for any reason whatsoever."* The IRS ruled that such a right is extraordinary and outside the scope of a business purpose restriction. According to the Service, this right "obviates" the fiduciary duty ordinarily imposed on the general partner, and clothes the general partner with authority to withhold income for reasons unrelated to the conduct of the partnership.

The IRS argument totally ignores *Byrum*. None of the cases cited by the IRS in the TAM support its position because they all involve trust law and not the fiduciary obligations of a general partner. The cases cited in the TAM relate to whether a gift in trust qualifies as a present interest gift.

The provision in the FLP agreement allowing the general partner to retain income "for any reason whatsoever" must be limited by the general partner's fiduciary obli-

gation. The IRS may not pick and choose those powers subject to the obligation and those powers not subject to the obligation. All the general partner's powers are subject to the obligation that they may not be exercised for personal or family advantage. The analysis in *Ltr. Rul. 9415007* is the correct analysis because it follows the decision in *Byrum*. That letter ruling stated that "the general partner's powers are not the equivalent of a trustee's discretionary authority to distribute or withhold trust income or property (i.e., a power that generally results in the characterization of a gift to such a trust as a gift of a future interest)."

2. *The FLP interests were subject to several restrictions.* The limited partners in TAM 9751003 could not transfer or assign the gift interests, nor could they withdraw from the partnership or receive a return of capital until 2022. In contrast, the donor, Mary, was free to transfer or assign her interest. These restrictions are fairly common in FLP agreements. The TAM concluded that "although title vested in the donees, the limited partnership interests lacked the tangible and immediate economic benefit" required for a present interest in property.

This "immediate economic benefit" argument was used in the

trust cases to deny that a transfer in trust was a present interest. TAM 9751003 argued that because of the extensive restrictions in the partnership agreement, the limited partners could not immediately enjoy the benefits of the gift and, therefore, the transfers created a future interest.

In *Ltr. Rul. 9415007*, the limited partnership interests were subject to various restrictions, although these restrictions do not appear to have been as extensive as those in the TAM. For example, in the 1994 letter ruling, the right to sell or assign one's partnership interest was subject to a right of first refusal in the other partners. If the transfer of an FLP interest is outright, it should constitute a present interest. On the other hand, it may be that a court will determine that an absolute prohibition on sale or assignment gives rise to a future interest.

Planning under the TAM

Cautious practitioners may want to structure FLP restrictions in the manner set forth in *Ltr. Rul. 9415007* rather than providing for an absolute prohibition on sale or assignment. ■

¹ 408 U.S. 125, 30 AFTR2d 72-5811, 72-2 USTC ¶12,859 (S.Ct., 1972).