GRAY REED

IRS Unsuccessful in Attack on Gifts of Family Limited Partnership Interests

Gray Reed & McGraw Legal Alert

July 19, 2012

The United States Tax Court recently established new parameters for qualifying gifts as annual exclusion gifts. Under current law, a person has a right to give away up to $13,000 of assets each year, to as many people as the donor sees fit, free of gift tax. This is commonly referred to as the "annual exclusion." In order to be considered a gift eligible for the annual exclusion, the gift has to be a gift of a "present interest," and not just a future right or benefit.

Courts have held that in order to qualify as a present interest, the gift must confer a present economic benefit by reason of (i) the use, possession or enjoyment of the property or (ii) the use, possession or enjoyment of income from the property.

A question has lingered over whether gifts of family limited partnership interests are "present interests" that qualify for the annual exclusion. Most partnership agreements provide restrictions on transfers on partnership interests to ensure that the property remains in the family. Depending upon the restrictions contained in the partnership agreement, the IRS and some courts have viewed these transfer restrictions as preventing the recipient from having an immediate right to use or enjoy the limited partnership interest in a meaningful way and therefore finding that the gift of a limited partnership interest does not qualify as the gift of a present interest.

In *Estate of George H. Wimmer*, TC Memo 2012-157, the United States Tax Court recently considered this issue again. Reiterating its holding in prior cases, the Tax Court held that in order for the transfer of a limited partnership interest to qualify for the annual gift tax exclusion, the donor must prove three things:

- That the partnership would generate income,
- That some portion of the income would flow steadily to the donees, and
- That such income is readily ascertainable.

The partnership at issue in *Wimmer* was funded with publicly traded stocks which paid dividends quarterly. The Tax Court therefore easily found that requirements one and three, above, had been met.

With respect to requirement two, the court found that despite the fact that the partnership agreement granted discretion to the general partners as to whether or not distributions would be made to the partners, the general partners owed fiduciary duties to the donee limited partners as a matter of law. Because one of the donees was an irrevocable trust with no other assets, the only way such trust would be able to pay its share of income tax would be for the partnership to make distributions of income. Based on these unique facts, the court held that in order to carry out its fiduciary duties, the general partner would be legally required to ensure a steady flow of income to the donees.

Obviously limited partners in many family partnerships will have personal assets from which income may be derived in addition to the partnership interest. Additionally, in Texas, general partners owe a "duty of care and loyalty" to limited partners (analogous but not identical to the "fiduciary duty" in the *Wimmer* case). Therefore, the second requirement might or might not be met in a given case, depending upon the terms of the partnership agreement as well as the unique financial circumstances of the donee limited partners. Moreover, family limited partnerships frequently hold unimproved real estate or other assets which do not generate regular income or whose income may not be readily ascertained, regardless of fiduciary obligations or the financial needs of the partners.

Therefore, to ensure gifts of limited partnership interests qualify for the annual exclusion and to mitigate the risk of an IRS challenge, we offer the following suggestions:

For gifts of limited partnership interests to be made in the future, we recommend either of the following:

- **"Put" Right for Limited Period.** Along with the assignment of the partnership interest, give the donee-partner the right for a limited period of time to sell the limited partnership interest back to the donor for its fair market value (limited to the annual exclusion amount), determined without regard to the existence of the put right. This provision (similar to the Crummey power frequently used in connection with the creation of life insurance trusts and other estate planning vehicles) could be included in the assignment document or could be included in the body of the partnership agreement itself. It should require the donor to substitute income producing property or cash equal in value to the value of the donated partnership interest at the election of the donor.

  -OR-

- **Withdrawal Power From Partnership.** Provide in the limited partnership agreement that the donee-partners have a withdrawal power with respect to gifts of limited partnership interests to require the partnership to redeem limited partnership interests for a limited period of time after each gift for an amount of money equal to the fair market value of such interests.

For gifts of limited partnership interests made in the past:

File Gift Tax Return for Year of Gift.

If a gift tax return has not already been filed, consider filing such a gift tax return now to commence the running of the normal three-year statute of limitations period. If the IRS does not challenge the gift within the three-year statute period, the gift's status as a "present interest" should in most cases be free from challenge. In case the IRS does challenge the gift, it will be easier to defend it now than at some indeterminate time in the future (probably in connection with an estate tax return for a deceased donor).

If you have any questions concerning this new case, please contact Gray Reed and McGraw attorneys Norm Lofgren or Jennifer Gurevitz.

About Gray Reed & McGraw

Founded in 1985, Gray Reed & McGraw is a full-service, Texas based law firm with more than 110 lawyers practicing in Houston, Dallas and Tyler. Gray Reed & McGraw offers a wide range of legal services including business litigation, corporate transactions, oil & gas, tax planning and litigation, real estate, healthcare, trusts and estates, employment law, family law, and bankruptcy. For more information, visit www.grayreed.com.

This Gray Reed & McGraw Alert is issued for informational purposes only and is not intended to be construed or used as general legal advice.