What to Consider Before You Accept an Interest in a Family Limited Partnership

by Douglas Stein, Esq.*

Charitable family limited partnerhsips, or FLPs, have been highly publicized over the past several years. Many taxpayers have partnership interests they wish to donate to charity as a part of their charitable giving program. However, tax exempts must consider a host of issues before accepting any partnership interest.

A private foundation's level of ownership in an operating business which is not conducted as a charitable activity is limited by Section 4943. Specific time periods are prescribed for disposition of such holdings received by the private foundation through donation or inheritance. The basic rule is that the combined ownership of the private foundation and its insiders in a business enterprise of any form, including a partnership, must not exceed 20%. These ownership limitations apply whether or not the business produces a profit. If the partnership is conducting an active trade or business, then the foundation must dispose of its interest within five years, otherwise, it will be subject to excess business holdings tax equal to 5% of the highest value of the excessive amounts of the interest each year. The tax is payable for each tax year during the taxable period.

However, if the partnership interest held by the private foundation obtains at least 95% of its gross income from the passive sources listed in Sections 512(b)(1), (2), (3), and (5), the partnership is not considered a business. Essentially, if 95% of the gross income of the partnership is from dividends, interests, annuities, royalties, rental income, or gains or losses from sales, exchanges or other dispositions of property other than stock held for regular sale to customers, the charity will not be deemed to have excess business holdings and therefore, can hold the interest as long as it desires.

Jeopardizing Investments

A private foundation and the manager of the private foundation are subject to a two-tier excise tax for making investments which jeopardize the private foundation's exempt purpose. If a jeopardizing investment is made, the private foundation must pay a tax of 5% of the amount of the investment for each year or part thereof in which the investment was made. In addition, the foundation manager, who knowingly and willfully participated in making the investment decision is also subject to a 5% penalty. However, that liability is limited to $5,000 per investment.

The second tier of tax is 25% of the investment, and is imposed whenever an initial tax is imposed, and the investment is not removed from jeopardy within the taxable period. Generally speaking, the taxable period is the earlier to occur of the date of mailing the deficiency notice by the IRS, the date on which the tax is imposed, or the date on which the amount so invested is removed from jeopardy.

Although it is difficult to point to any given investment as being per se a jeopardizing investment, certain trends have developed. Specifically, investments in speculative property, which may include investments in partnerships, tend to be jeopardizing investments. The regulations make clear that property received as a gift or bequest is not a jeopardizing investment, no matter how imprudent it may be. However, if the foundation purchased the interest in a bargain sale transaction the foundation would be deemed to have invested in the partnership and thereby possibly violate the jeopardizing investment rule. In light of the regulations, foundations should make certain not to engage in a bargain sale transactions or purchase a partnership interest. However, they may accept those interests as outright gifts or bequests.

After analyzing the receipt of a partnership interest under the above statutes, it appears clear that the acceptance by gift or bequest of a partnership interest has numerous tax issues associated with it, and may or may not affect a charity's ability to remain income and penalty free. Charities and private foundations should develop gift acceptance policies which directly deal with accepting interests in partnerships. Once the charity has concluded its analysis of the of the above, it must then determine if they will accept the partnership interest.

Self Dealing

As with excess business holdings and jeopardizing investments, self dealing only applies to private foundations. Self dealing consists of any direct or indirect transaction between a private foundation and a disqualified person involving the sale, exchange or leasing of property, lending of money or other extension of credit, furnishing goods, services or facilities, or payment of compensation or payment/reimbursement of certain expenses. Although the foregoing list is not comprehensive, the charity should note that the regulations, case law and IRS pronouncements have greatly expanded and refined what will constitute an act of self dealing. The private foundation that is accepting an interest in a partnership must make certain that all transactions between itself and the partnership are an arm's-length transaction.

Private foundations should make sure a partnership interest doesn't lead to self-dealing.

If a private foundation violates the self dealing rules, an excise tax is imposed on the participating foundation managers. The tax will equal 2.5% of the amount involved with respect to the act of self dealing for each year (or part thereof), in any taxable period unless the foundation manager's participation is not willful and is due to reasonable cause. This tax rate will increase to 50% if the act is not corrected within the taxable year and if the foundation manager refused to agree to part or all of the correction. The maximum amount imposed on a participating foundation manager with respect to any act of self dealing is $10,000. Prior to accepting any partnership interest, it is highly recommended that the private foundation carefully analyze the circumstances to insure that they are not engaging in an act of self dealing.

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Intermediate Sanctions

A transaction with a public charity or private foundation may result in private inurement, or excess benefit if a donor or some other private person is deemed to receive an excess benefit from a transaction. On January 23, the IRS issued final regulations which impose excise taxes on disqualified persons who participate in excess benefit transactions with public charities. In general, the term "excess benefit transaction" means any transaction in which an economic benefit is provided by a tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration. The regulations state an excess benefit transaction will not ordinarily be considered knowing if the manager relies on a reasoned, written opinion by legal counsel, certified public accountant or independent valuation expert.

Unrelated Business Income Tax

Under Section 513(a), an exempt is also taxed on its unrelated business income if the income is unrelated to the furtherance of the charity's goals. Income is unrelated if (1) it is income from a trade or business; (2) the trade or business is regularly carried on by the organization; and (3) the conduct of the trade or business is not substantially related to the performance of the organization's exempt functions. In *Leila G. Newhall Unitrust*, 104 TC 236, the Tax Court held that income that flows through a partnership to a charitable organization will retain the character of that income as realized at the partnership level. In essence, if the partnership has income which, if the charity received directly would have constituted UBIT, the charity will deemed to have received the UBIT income. The mere presence of the partnership does not change the status of the income. Charities accepting partnership interests will want to ensure that any partnership agreement will specifically prohibit the managing partner from purchasing assets or generating income through any activity that would constitute UBIT. Since avoiding taxation is of paramount concern, the charity should view this as a necessary requirement before accepting any partnership interest.

In sum, charities should be careful before accepting any interest in a partnership. The charity must carefully analyze not only the tax consequences associated with accepting the partnership interest, but they must also determine if they can convert their partnership interests into cash and whether the partnership interest coincides with their charitable goals. ■