FLPs WITH BUSINESS PURPOSE MORE LIKELY TO PASS IRS MUSTER

Wealthy families thinking of establishing a family limited partnership in order to save gift and estate taxes need to keep one key point in mind: an FLP is more likely to pass IRS muster if it can demonstrate a bona fide business purpose and operate in a business-like manner.

As FLPs (and the family limited liability company where credit protection is a concern) have grown in popularity in recent years, taxpayers and the Internal Revenue Service have been engaged in a tug of war over whether an FLP is a legitimate vehicle for the reduction of gift and estate taxes. Sometimes the IRS wins, sometimes the taxpayers win. But out of the tussle guidelines are emerging that may clarify the issue for taxpayers.

The intent behind most typical family limited partnerships is straightforward, even if the FLP itself is complex. A parent transfers assets, such as a family business, stock, or real estate, to an FLP and then gifts most of the shares of the FLP to the children. The parent typically retains one or two percent ownership as general partner, effectively controlling management of the FLP.

Because the children's management control and marketability of their shares are severely limited, the value of their shares is treated as less than the shares' proportional net asset value of the FLP. Thus, the value of the gifted shares is discounted for tax purposes, sometimes as much as 40 percent or more. That saves the parent potential gift taxes, and because the assets have been moved out of the parent's estate, it saves potential estate taxes.

The IRS has generally lost the gift-tax issue on appeal to tax courts, but it has had more success in arguing that a parent never effectively relinquished control or use of the assets, and thus the assets should be included at an undiscounted value in the parent's taxable estate upon the parent's death.

A string of recent court cases appear to suggest some guidelines that families and their financial and legal advisors should consider when deciding whether and how to establish an FLP that can pass the IRS challenge for both gift and estate taxes. The key often turns on whether the facts suggest that the FLP is a "sham" whose intent is merely to avoid taxes, or whether it was established for legitimate business reasons, with a side benefit of saving taxes. Guidelines suggested by these cases include

Is an FLP appropriate? FLPs generally are for people likely to face gift and estate taxes. But even they may find other tax-saving strategies more cost effective, less complex, and less vulnerable to IRS challenge.

Have a valid business purpose. This is still a gray area. Commentators think you'll be on safest ground if the FLP includes an *active* family business or investments that requires active management by the FLP's partners, such as rental property. One recent ruling went against a taxpayer in part because the FLP mainly held mostly marketable securities with no apparent business purpose for holding them. But in an another case, an appeals court ruled in favor of the taxpayer because in addition to active management of assets, the FLP provided such valid business purposes as protection against creditors and a reduction of intra-family disputes that had previously resulted in litigation.

Spell out the business purpose. The partnership documents should spell out in detail the FLP's business purposes, and the family should operate it as a business.

Don't commingle personal property. One of the quickest ways to draw IRS scrutiny is to stuff an FLP with personal assets such as a primary residence or vacation property. The taxpayer lost in one case because the primary residence was gifted to the FLP, yet the taxpayer continued to live in it rent free. You may make this work (such as paying fair-market rent to the FLP), but be prepared for a challenge.

Don't use FLP as your personal piggy bank. It's best to retain sufficient personal assets outside the FLP to live on and avoid drawing on FLP assets for living expenses.

Avoid death-bed formations of FLPs. There have been allowable exceptions to this practice, but it definitely invites IRS attention.

Maintain the general partner's fiduciary responsibility. Waiving the responsibility in the agreement raises questions about the partnership's validity.

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