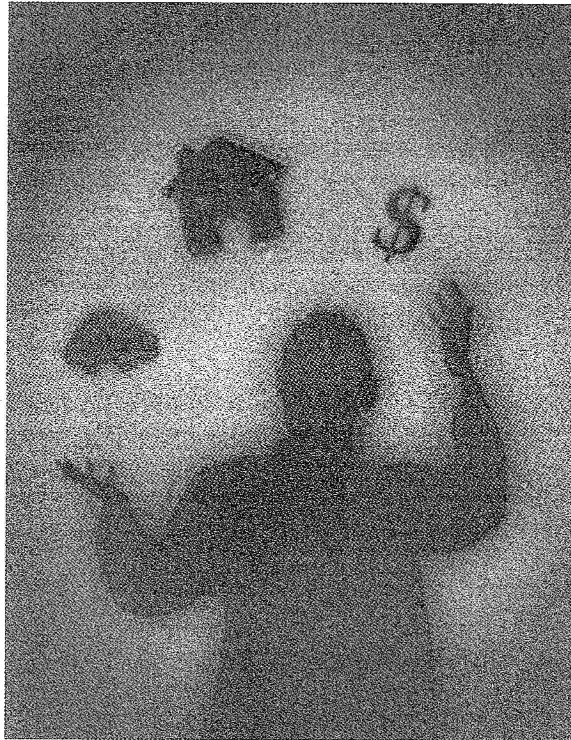

Family Limited Partnerships

FLPs Can Work For Your Client and You Can Help the Process

by Ira S. Feldman, CPA, CVA, CEP

The professional "buzz" in estate planning is currently all about Family Limited Partnerships. (In the context here, FLP refers to any form of family entity including Partnerships, LLCs, etc.). Unfortunately, this professional discourse seems to be solely focused around achieving, or in the case of the most recent tax cases on the subject, not achieving, the expected discount on value of the decedent's interest in the Family Limited Partnership for estate tax filing purposes.

Do's and Don'ts of FLPs

1. "Minor" partners should contribute their own property to the family venture. Use proceeds of prior family gifts.
2. The managing member should NOT be the senior generation. Give them some control over governance. In some cases, use a corporate managing member not controlled by the senior members.
3. Provide for succession of management in the younger generation. The sooner, the better.
4. Do NOT transfer substantially all of the senior members' assets; and do transfer some assets requiring management. Leave the home out. The "senior" members should have a base level of support outside of the FLP.
5. Don't forget to transfer title to the assets!
6. Do get insurance on the assets - both liability and property damage.
7. Do NOT commingle personal and FLP assets.
8. Prepare a budget. Use fiscal responsibility.
9. ALL distributions must follow the operating agreement and be proportional to ownership interests.
10. Put "clothes" on the "emperor." Make the FLP look like the real entity it is.
11. If the LLC assets consist of a business interest or significant real estate, be careful to clearly define the LLC's role in the investment. Don't inadvertently change the character of the investment.
12. Prepare management reports to all members at least annually-not one prepared by the attorney.
13. Better yet, have an annual meeting of the members in a "comfortable" place where they can take time out to update all members on the family matters and renew old feuds. Take minutes of the meeting. The meeting is deductible to the LLC and they can even bring their professional advisors!!

If we carefully read the more recent and, unfortunately, mostly unfavorable tax decisions, we can develop a planning list of things that could be done right in order to meet the tax expectations. I will cite one example in this article. The Fifth Circuit Court of Appeals decision was finally issued in what is most commonly referred to as *Strangi-II*[1]. The following brief background to the case will illustrate the point "bad facts make bad law."

The Tax Court initially held for the Estate and cancelled the IRS proposed assessment of $2.5 million in additional Estate Taxes on the increased value of the $10 million in assets transferred from the decedent to the FLP. However, just prior to trial, the IRS raised a new legal theory that the Tax Court then ruled was too late to consider. The new theory involved using IRC §2036(a) to draw the assets transferred to the FLP back into the Estate at full value because nothing happened. They argued that the transfer to the FLP was merely a recycling of value. The Fifth Circuit remand back to the Tax Court considered this theory and after doing so, the bad facts produced a bad Tax Court decision *against* the Estate. On appeal to the Fifth Circuit (for the second time-*Strangi II*), the Court affirmed the IRS theory.

While professional "techies" will busy themselves with intricate technical arguments, a clear reading of the case shows the direction that most Courts are taking these days. That is, the IRS has picked the worst factual situations to challenge, and that has made easy decisions for the Courts notwithstanding the technical arguments proposed by taxpayers. In *Strangi*, the bad facts corrupted the case against the taxpayer, the least of which was the packaged Fortress Estate Plan purchased and implemented by the decedent's son-in-law lawyer, Michael Gulig (whose name the Fifth Circuit adopted for the decision). Read the case. You will see a good outline of what you can do to assist your client to establish a good fact pattern. Also see

Estate of Schutt (TCM 2005-126) for the facts that work.

The purpose of this article is not to belabor the technical arguments. Frankly, I have seen very few cases where those technical arguments have been applied either by Courts or audits to good facts. In fact, my experience on Estate audits is just the reverse. And therein lies where we can help our client make those FLPs work.

Perhaps the reason estates are having IRS difficulties is that they have placed Estate Tax savings too high on the list of purposes for an FLP. These purposes should include the following (note where I have *intentionally* placed the tax savings):

1. Family business/investment succession
2. Management during seniors' lifetime and thereafter
3. Liability protection
4. Avoid spendthrift-preserve assets
5. Income tax "sharing" among family members
6. Achieve Estate Tax Savings (DISCOUNTS)
7. Create more work for your accountant

I threw that last one in to see if you were reading carefully. Just think, if Estate Tax is repealed, wouldn't there still be reasons for you to encourage clients to undertake FLPs?

Think about the last few FLPs you helped your clients implement. Where was the cart and where was the horse? Did your client buy a "package" program? I'm not only referring to those that are sold by purveyors of Estate Plans through commercial outlets, but also those lawyers and document preparers who focus solely on package documentation for their clients. Most of those packages have the correct wrapping, bows, and other paraphernalia, but when you open the box, the contents are rotten or non existent. That's where the accountant comes in. I am not referring to the role of undertaker; instead, let's help the client put meat on the bones. The CPA is in the best position to help his client do that task.

It's the implementation — that's where the FLP fails to achieve its Estate Tax savings. The Courts don't imply that the general principal of the discount is wrong; in fact, IRS challenges on the basis that discounts as a concept is improper have failed. The problem is that the implementation has failed or been non-existent.

You can help your client to implement a Family Limited Partnership by including the following on your implementation list:

- **Assets to be transferred** — careful selection and calculation of their value.
- **Follow the Operating Agreement to the letter** — amend it where necessary to accomplish the family goals. Canned Agreements are not as desirable as one that is more tailored to your client's family situation.
- **Obtain independent valuations** for the initial gifts, and significant future gifts.
- **File gift tax returns and check the "discount" box.** Be sure to attach a plethora of information — see the instructions for disclosures.
- **Have a "post-formation" meeting** — client and professional advisors — to double check implementation.

Do's and Don'ts for your Clients' Family Limited Partnership

You can assist your client by working with the attorney and other advisors during the implementation phase and paying careful attention to the do's and don'ts in the attached sidebar on the preceeding page. This is a valuable service you can render to your client. Most attorneys are not focused on this level of detail. The charges incurred for this service will be modest compared to the cost of defending the discount taken on the value of the FLP after you file the Estate Tax return. And, frankly, in today's atmosphere, if you don't assist your client in these matters, your client may ask (sometime through a lawsuit later on) why you didn't offer this assistance.

Clients' expectations regarding FLPs are often misplaced. They have placed too much emphasis on Estate Tax savings and not enough on the other reasons for forming this family enterprise. While the "techies" are arguing the pros and cons of tax theory, the courts clearly indicate that the problem is with implementation. Bad facts make for bad cases. You can assist your client and the other advisors in implementing and maintaining the FLP in a form that will achieve the tax result, not to mention the other advantages of such entities. See the Do's and Don'ts sidebar for specifics on what you can do. **AZ CPA**

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Endnotes

[1] *Albert Strangi, CA5 No 03-60992, July 15, 2005 (96AFTR 2005-5048). The latest decision is reported under the name of Gulig.*