Estate Planning
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Estate, Tax and Family Wealth Preservation Planning For Advisors

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Family Limited Partnerships

In a battle over FLP's, taxpayers recently won a skirmish with the IRS, which hasn't waived the white flag yet.

The IRS Campaign against Family Limited Partnerships (FLP's) recently suffered a striking loss in court. The case involved $1.5 million worth of stocks and Texas ranchland tucked into a family partnership by one Elsie Church just before she died seven years ago. A federal district court judge in San Antonio ruled that the Church holdings could be valued at less than half that for estate tax purposes.

Although it has lost a few key cases, the IRS still dislikes FLP's and remains unrelenting in its scrutiny of them. With the IRS losing on the law, it will train its guns on taxpayers who make sloppy mistakes.

How is it possible to make half an estate's taxable value disappear? FLP's shelter all manner of assets—stock, real estate, cash—with the parents usually remaining in control as general partners while giving the kids assets in the form of limited partnership units. A hypothetical outside buyer, since he couldn't control asset management or force the partnership's liquidation, would demand a discount from the underlying value of the assets in the FLP. For the Churches, that discount amounted to more than 50%.

Here are some valuable tips on FLP's to pass along to your clients:

Don't tap partnership money for personal uses. Unless you treat your FLP as if it's real, the IRS and courts won't. Consider the $1.6 million partnership set up by Charles Reichardt of Alamo Heights, Tex., and his two children. In March, U.S. Tax Court Judge John Colvin slapped it with a more than $400,000 estate tax bill.

Why? Reichardt used partnership funds to pay personal expenses. If you need cash, you must first distribute it from the FLP to all partners.

Don't set up a partnership on the cheap – The Reichardt family tried to cut costs by handling the accounting and the property transfers themselves, with devastating results. Appearances are now very important.

Don't wait until you're on your deathbed to set up a partnership. Congress has eliminated most of the old restrictions on gifts made in anticipation of death. Tell that to the IRS. In the San Antonio case, the IRS wouldn't settle because it was obsessed with the fact that the FLP was created just two days before her demise. (The judge found this irrelevant and coincidental: She died of a sudden heart attack.)

Don't put your home into a partnership. It makes judges skeptical that the FLP was really set up for a legitimate business purpose, other than just saving taxes.

If you do plunk your home into a partnership, you must pay rent. (Reichardt didn't.) And the house will no longer qualify for the $500,000 per couple exemption from capital gains taxes. Another vehicle, called a Qualified Personal Residence Trust, is usually a better way to pass on your house at a discount. (see our Feb. 2000 *Fast* Faxts).

Put a mix of assets into the partnership. The courts haven't yet ruled explicitly on whether an FLP containing only publicly traded stocks has a business purpose. But the IRS auditors and appeals officers are allowing 25% to 45% discounts for all-securities partnerships, done right.

"The reason for my trip? Business! What other reason is there?"

Don't mix partnerships and IRAs. We met a prospective client with a $15 million net work who had put his individual retirement account into his FLP. (Yep. The man had bought a forms book at a seminar.) Such a move legally terminates the IRA; income taxes on the whole amount in the IRA are immediately due.

Be wary of how you mix partnerships and charity. Former Pennzoil president, Blain Kerr gave a few FLP units to charity to demonstrate that the family couldn't liquidate the FLP by itself. The tax court upheld the move.

A different ploy, called a charitable FLP, is much dicier. In this one, the taxpayer puts hugely appreciated assets in a partnership and donates most of the units to charity. The assets are then sold, with most of the taxable gains attributed to the tax-exempt charity. But the donor retains management control.

Later, when the charity tires of the partnership's minimal payouts – remember, the donor is still in control – the charity sells its interests back to the donor's heirs at a steep discount and with the capital gains laundered. Talk about audit bait.

We would be pleased to help you and your clients learn more about the pitfalls and potential of FLP's. Give us a call.

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