How to Avoid the Attention of the IRS When Making Family Limited Partnership Gifts

By Bruce A. Johnson, ASA

Bruce A. Johnson, ASA

Standards are fundamental to lending. Financing necessarily involves judging both risk and reward and standards enable these judgments to be made in a consistent, predictable fashion. Lenders must evaluate a borrower's ability to repay; therefore they must understand the borrower's financial capabilities and the value of any offered collateral. Similarly, borrowers must understand lender's terms and cost of funds to be borrowed.

Without standards these steps can be conducted but not in a meaningful way. Standards allow participants in the financial markets to make comparative judgments regarding alternatives. Borrowers can reasonable make comparisons among different lenders and lenders can consider different lending opportunities. Investors can compare different lenders and determine which to invest in. With standards, participants can be reasonable assured of speaking the same language. Without standards, evaluating data in order to reach a sound conclusion is highly challenged if not impossible.

As global commerce has increased, so have international standards. For example, international banking standards for capital requirements have been set with the Basel Accords beginning in 1988 with Basel I, in 2004 with Basel II and in 2013 with Basel III. Basel II emphasized three "pillars" including Minimum Capital Requirements, expectations for a Supervisory Review process for both internal management and for supervisors, and Market Discipline which standardizes disclosures to help market participants understand an institution's capital adequacy.

Valuations are fundamental to lending. Lenders must have an understanding of the worth of collateral offered to support a loan. Valuations are a snapshot in time of the estimated value of the collateral, not a guarantee of its worth over the term of a loan and events subsequent to a valuation may significantly change market conditions and the value of the collateral. Nonetheless, valuations properly conducted by an unbiased valuer provide critical insight into the economics of the credit decision.

Standards underlie all valuations. Clients rely upon standards when engaging valuers for assignments. The standards set expectations for the work product. Adherence to standards allows the client and any other users, to gauge the credibility of the value estimate. Trust in that estimate is diminished to the extent the valuer deviates from the agreed-upon standard.

Standards set expectations for users and set performance criteria for valuers. To understand the valuation, one must understand the standards it was prepared under. Any review of a submitted valuation must start with a complete understanding of the standard it was prepared under.

There are four common elements underlying all valuations which must be addressed by a valuation standard. These four elements provide a foundation like legs on a chair to support the valuation and its credibility.

The first is the definition of value to be used. There are a surprising number of definitions and this is a fundamental decision that reverberates through the rest of the assignment. Is the value estimate to reflect the value to another market participant or to the current owner? Does the definition allow for the most probable value, the highest, or the lowest? If the definition presumes a hypothetical sale, are the parties to the transaction knowledgeable? Are the parties to the transaction unrelated? To understand a valuation, one must first understand the type of value used.

"The valuer is responsible for understanding the user's intended use and for exercising professional judgment in determining the scope of work necessary to provide an assignment result that will be credible for the user in the specific context."

The second fundamental element is the relationship of the valuer to the parties and to the asset under consideration. If the valuer has a current or anticipated future relationship with the parties or the asset being valued, or has a vested interest in the outcome, the potential for bias on behalf of the valuer calls into question the credibility of the assignment result and can negate the user's confidence in the value estimate. If the valuer does not have a relationship with the parties or the asset and does not have an interest in outcome of the assignment result, the question of bias is removed and the user can better trust the assignment results.

The third fundamental element is the valuer's scope of work. The scope of work is the steps the valuer took to reach the valuation conclusion. This is the extent to which the valuer:

- Identified the property and its characteristics
- Searched for market data with which to value the property
- Verified the market data considered
- Conducted analyses using the market data
- Reconciled estimates from analyses if more than one was used

The scope of work can reasonably vary depending upon the user's intended use of the assignment results. The valuer is responsible for understanding the user's intended use and for exercising professional judgment in determining the scope of work necessary to provide an assignment result that will be credible for the user in the specific context.

The fourth is the manner in which the valuation results are communicated with the client. Is the report to be written or is it oral? Is the asset to be described and if so to what extent? Is the supporting data to be provided or simply the concluded inputs used in the analyses? Is the analysis itself to be provided or simply the conclusion? These aspects should be understood and agreed upon by both client and valuer.

Which standard is to be used? In some cases, neither the client nor the valuer have a choice in which standard is to be met. Standards can be imposed by regulators or professional organizations. In other circumstances no regulations require adherence to a particular standard, in which case the valuer may still choose to comply with a standard.

And why in the world would anyone chose to bring on standard compliance upon themselves? For the valuer, standards enhance credibility and trust in the assignment results. It helps frame the client's expectations which can help the valuer in the event of a subsequent dispute with the client.

Globally, numerous standards exist. Some were developed by professional organizations, others by local or national governmental agencies. Regardless of the individual merits of such standards, the drawback they share is the burden they place on users who must re-learn a new standard each time a border is crossed or another professional group is encountered.

International Valuation Standards are published by the International Valuation Council, a not for profit organization. International Valuation Standards provide the best opportunity for consistency and uniformity of expectations for valuation of assets and liabilities globally. Use of these standards will reduce the variations seen in valuations prepared under differing standards making review and acceptance of the valuation easier for lenders and regulators alike. Sir David Tweedie, Chairman of the IVSC Board of Trustees noted: "It makes no sense for a similar valuation being undertaken in Moscow, Madrid or Melbourne to be conducted in entirely different ways. The financial community needs the valuation profession to come up with one accepted set of high quality, global valuation standards."

A common set of standards would benefit lenders, borrowers, investors and valuers providing services to lenders. Basel is setting common standards for capital adequacy. The International Valuation Standards has created common standards for valuation. So, as banks run on standards, the International Valuation Standards will help create a level and consistent road.

The formation and transfer of assets to a Family Limited Partnership (FLP) or Limited Liability Company (LLC) can provide multiple benefits for individuals and families including asset protection, dispute resolution and favorable tax benefits for gifting. Typically, each state has its own form of a Uniform Limited Partnership Act or Limited Liability Act that allows for the formation of partnerships and LLCs that can hold real estate, marketable securities and other assets. The management of the assets can be controlled by a general partner or managing member while the remaining interests can be transferred to other family members. These transfers of noncontrolling interests can benefit from lower taxation due to discounts for lack of control and lack of marketability.

However, many FLPs and LLCs used for gifting receive special scrutiny by the Internal Revenue Service (IRS). In fact, certain IRS officials have stated (off the record) that every FLP will be examined. The primary reason that they are unpopular with the IRS is due to the tax benefits received by the donor that lower revenue to the Department of Treasury.

Formation and Operation

In the 1990's and 2000's, the IRS challenged the formation of FLPs using Internal Revenue Code (IRC) §2703 and IRC §2704 which questioned the FLP's validity under tax law. The basic challenge was an attempt to invalidate the FLP partnership agreement.

After several less than successful attempts using IRC §2703 and IRC §2704, the IRS moved on to looking at the operation of the partnership. Primarily, they have used IRC §2036 to successfully invalidate FLPs due to taxpayers not respecting the business purpose of the FLP and, in general, commingling personal and business funds. IRC §2036 is triggered where a decedent has retained possession, enjoyment, or right to income, or has retained control over who enjoys the income from the property.

A risk-adverse taxpayer can properly set up their partnership or LLC, document their gift transaction and potentially avoid the scrutiny of the IRS by following these simple steps:

1. Comply with state law for the formation and operation of the entity.

2. Formally transfer the assets to the FLP or LLC at formation and legally hold any real estate or brokerage accounts in the name of the FLP or LLC.

3. Only use limited partnership or LLC assets for personal enjoyment by leasing the assets from the FLP or LLC and never pay personal expenses with partnership or LLC income. If a FLP or LLC owns real estate that you want to use, set up a lease agreement at market value. If you need money, pay a market salary or management fee to the taxpayer for services rendered.

4. Get a business appraisal done to document the value of every transfer.

5. It is typically recommended that a taxpayer should not put all (90%-100%) of their assets in the partnership or LLC so there are no outside resources to pay for living expenses.

Valuation Issues

In almost every IRS challenge to FLPs or LLCs, the case is focused around valuation issues. If a limited partnership or LLC interest was sold to a third party in an arm's length transaction, it would most likely not sell for its pro rata value of the whole. For example, if a FLP has assets of $10,000,000, a 10% limited partnership interest would not sell for $1,000,000 (10% x $10,000,000 = $1,000,000). Depending on the assets involved, it would likely sell for 25% to 45% less than its pro rata value. This discount from the total or net asset value of the partnership is due to a limited partnership suffering from lack of control and lack of marketability.

When valuing limited partnership or LLC interests, it continues to be common practice for many business appraisers to simply derive the net asset value of the partnership or LLC and then apply discounts for lack of control and lack of marketability based upon average discounts found in various published studies. This is referred to as the Cost or Asset Based Approach. The Tax Court has been particularly critical of this methodology due to the subjectivity involved in determining the discounts for lack of control and lack of marketability including:

- the wide range of discounts observed in the studies,
- the lack of supporting data on the entities contained within the studies,
- the inability of the appraiser to make adequate comparisons between the partnership/LLC being valued and the entities contained in the studies,
- improperly relying on prior court rulings to derive discounts.

If a limited partnership interest or LLC interest is noncontrolling, the limited partner or member typically cannot exercise control over the sale of the assets of the partnership. Rather, the limited partner or member looks primarily to the income-generating ability of the partnership or LLC and the possible sale of assets at a future point in time to realize a return on their ownership interest. To adequately take into consideration the primary factors that influence the value of a limited partnership or LLC interest, appraisers should consider the use of both the Income Approach and Market Approach in their calculation of value. The Income Approach allows the appraiser to give consideration to the income generating and distribution-paying capacity of the interest. The Market Approach examines alternative investments to determine a reasonable price of the LP or LLC interest as compared to a publicly traded interests with similar characteristics in terms of asset type, profitability and leverage.

Steps for a Successful Gift

So what steps can a taxpayer take when forming and gifting interests in a FLP or LLC to reduce the chances of an IRS challenge down the road?

1. Hire experienced legal and accounting counsel – As discussed, the IRS frequently challenges FLPs or LLCs based on how they were formed and whether the entity has been operated in accordance with the rules set up in the formation documents. A taxpayer should keep separate checkbooks for their personal and partnership/LLC accounts and follow the legal formalities of the partnership/LLC agreement to prevent problems with the IRS in regard to legal and accounting issues.

2. Set a clear business purpose – In addition to reducing taxes on partnership/LLC transfers, FLPs and LLCs have other excellent benefits. They provide asset protection and management consolidation advantages. In addition, the rules in the formation documents set forth what to do in case of disputes (divorce, sale of an interest, etc.). When setting up the FLP or LLC, your clients should take the time to think through how they want disputes handled and how best to resolve conflicts between the partners or members, who will likely be their children and their spouses. Of course, an experienced attorney can help with this issue when writing the formation documents. Clearly stating the process to resolve problems can prevent gridlock in the future.

3. Document the value of any transfers – Some taxpayers decide to save money by not ordering a business appraisal. However, as in the Estate of Harvey Evenchik, v. the IRS, the taxpayer lost a significant tax deduction because he failed to have a proper business appraisal conducted. A properly prepared business appraisal is imperative to establish the value of the interest being transferred and also to start the statute of limitations on any transaction that requires a tax filing. This prevents the IRS from contesting the transaction years later and disrupting the client's estate tax plan.

4. Hire a full time, accredited business appraiser – In the business valuation profession, there are appraisers with a wealth of experience and expertise and, as in any profession, there are inexperienced appraisers that may not have the training and knowledge necessary, if your client's FLP or LLC transaction is audited by the IRS. When FLPs and LLCs are litigated, business appraisal experts who use incorrect valuation methodology and whose reports are poorly written, have failed to support their determination of value. Appraisers with U.S. Tax Court experience who are accredited by one of the major appraisal organizations, such as the American Society of Appraisers, tend to be the most qualified, but don't be shy to ask for references.

While there is no guarantee that your client's FLP or LLC gift will not be examined by the IRS -- and you cannot buy insurance to protect against the possibility of an audit -- following the above steps will help you and your client make good judgments for maximum benefits from their FLP or LLC. By selecting good counsel, thinking through the long-term considerations of the partnership or membership agreement and properly documenting their transactions with a business appraisal, FLPs and LLCs can be an excellent choice for asset protection, dispute resolution and wealth transfers.

—Bruce A. Johnson, ASA is a partner in the business valuation firm of Munroe, Park & Johnson, Inc. located in San Antonio, TX. He holds an undergraduate degree in Engineering and an MBA from Texas A&M University. Johnson is an Accredited Senior Appraiser with the American Society of Appraisers and an instructor and course developer for Partnership Profiles "Valuing Family Limited Partnerships" seminars. Johnson was the taxpayer expert in the Estate of Elsie J. Church, which was the first family limited partnership case ever to go to court. He is a member of the Business Valuation Committee for the American Society of Appraisers and a co-author of the Comprehensive Guide for the Valuation of Family Limited Partnerships. He has been published on a wide range of valuation topics including S Corp Tax Treatment, Discounts for Lack of Marketability and the Valuation of Family Limited Partnerships.