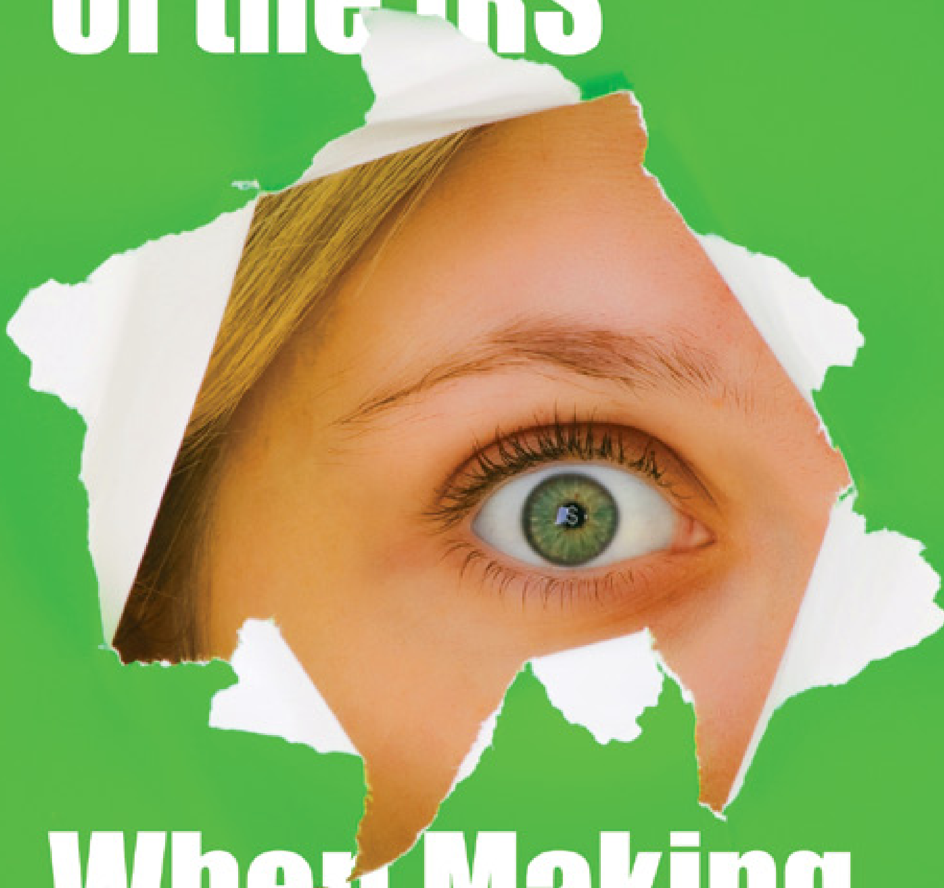
How to Avoid the Attention of the IRS



When Making Family Limited Partnership Gifts

By Bruce A. Johnson

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The widespread use of Family Limited Partnerships (FLP) among taxpayers is due to its effectiveness for asset protection, dispute resolution, and favorable tax benefits for gifting. However, FLPs are not popular with the Internal Revenue Service (IRS). In fact, certain IRS officials have stated (off the record) that every FLP will be examined.

So, if a taxpayer wants to draw the attention of the IRS, here are a few easy steps:

1. Do not formally transfer the assets to the FLP and keep any real estate or brokerage accounts in an individual name.
2. Use the limited partnership assets for personal enjoyment and pay personal expenses with partnership income.
3. Don't get a business appraisal done to document the value of every transfer.
4. Sell interests in the partnership for a higher value than the amount they are gifted within 12 months of each other.

On the other hand, risk-adverse taxpayers can properly document their gift transaction and avoid the scrutiny of the IRS.

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.[1] The basic challenge was an attempt to invalidate the FLP partnership agreement.[2]

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.[3] In contrast to the first three items listed above, a taxpayer who desires to not draw the attention of the IRS should:

1. Formally transfer the assets to the FLP at formation and legally hold any real estate or brokerage accounts in the name of the FLP.
2. Only use limited partnership assets for personal enjoyment by leasing the assets from the FLP and never pay personal expenses with partnership income. If an FLP 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.
3. A taxpayer should not put all (90 percent to 100 percent) of their assets in the partnership so there are no outside resources to pay for living expenses.

Valuation Issues

In almost every IRS challenge to FLPs, the case is focused around valuation issues. If a limited partnership 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 an FLP has assets of $10,000,000, a 10 percent limited partnership interest would not sell for $1,000,000 (10 percent x $10,000,000 = $1,000,000). Depending on the assets involved, it would likely sell for 25 percent to 45 percent 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. An investor would not buy a minority interest for it's pro rata value because he or she do not control the management or liquidation of the entity. Likewise, there is not a market for a privately-held interest in an FLP, so an investor would require a discount for lack of marketability to offset the risk of buying the interest.

When valuing limited partnership interests, it continues to be common practice for many business appraisers to simply derive the net asset value of the partnership 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 being valued and the entities contained in the studies
- improperly relying on prior court rulings to derive discounts

For example, in *Kelley v. Commissioner*, the Court rebuffed both the IRS and taxpayer experts in their determination of a discount for lack of control, stating:

> …we find neither expert particularly persuasive on [quantifying the discount for lack of control]…[4]

For the discount for lack of marketability, the Court rejected the taxpayer's calculation in *Peracchio v. Commissioner* because:

> [the taxpayer's expert] makes no attempt whatsoever to analyze the data from those [restricted stock] studies as they relate to the transferred interests. Rather, he simply lists the average discounts … asking us to accept on faith the premise that the approximate average of those results provides a reliable benchmark for the transferred interests. Absent any analytical support, we are unable to accept that premise…[5]

Because a limited partnership interest is noncontrolling, a limited partner typically cannot exercise control over the sale of the assets of the partnership. Rather, the limited partner looks primarily to the income-generating ability of the partnership 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 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 offers a look at alternative investments with similar characteristics in terms of asset type, profitability and leverage that can be purchased instead of the subject limited partnership interest.

The Income and Market Approaches offer a reliable way to value an interest in an FLP by quantifying risk and return using empirical data. For example, using the Income Approach, an appraiser can forecast available cash flow generated by the investment and discount it to present value using a discount rate that reflects the risk of the limited partnership. The Market Approach is useful to determine the value of a privately-held interest by using pricing ratios of comparable, but publicly-held investments. Revenue Ruling 59-60 states that the sale transactions for publicly-held interests should be considered when valuing privately-held interests. This is noted as follows:

> As generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries….

Various sources of data frequently used by appraisers to obtain comparative pricing multiples (such as a Price to NAV ratio) include, but are not limited to, closed-end funds and publicly-held limited partnerships. It is important to note that the Income and Market Approaches are regularly used by appraisers to value privately-held, non-controlling interests in operating companies. In addition, these are the methodologies typically used by investors in the capital market.

As more and more appraisers have begun using empirical data in the Income and Market Approach to value interests in limited partnerships (as opposed to average discounts based upon published studies), new information is being published to support the derivation of rates of return for the Income Approach and the determination of pricing ratios for the Market Approach. Typically, investors in third-party transactions do not use an Asset-Based Approach by applying average discounts to an investment's net asset value to determine the market value of an interest. Rather, investors seek an appropriate return on their investment (Income Approach) or compare the subject interest to alternative investments (Market Approach) to determine a reasonable value. While the discount from net asset value is important to a taxpayer and the IRS, a business appraiser should focus on the resulting rate of return using proven valuation methodology. Using a rate of return calculation and comparisons to alternative investments are the primary methods for supporting a value.[6]

Steps for a Successful Gift

So what steps can a taxpayer take when forming and gifting interests in an FLP 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 based on how they were formed and whether the partnership has been operated in accordance with the rules set up in the partnership agreement. A taxpayer should keep separate checkbooks for both personal and partnership accounts and follow the legal formalities of the partnership agreement to prevent problems with the IRS in regard to legal and accounting issues.
2. **Set a clear business purpose for the partnership** – In addition to reducing taxes on partnership transfers, FLPs have other excellent benefits. They provide asset protection and management consolidation advantages. In addition, the rules in the partnership agreement set forth what to do in case of disputes. When setting up the FLP, your clients should take the time to think through how they want disputes handled and how best to resolve conflicts between the partners, who will likely be their children and their spouses. Of course, an experienced attorney can help with this issue when writing the partnership agreement. 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 your 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 who may not have the training and knowledge necessary, if your client's FLP transaction is audited by the IRS. When FLPs are litigated, business appraisal experts who use incorrect valuation methodology and whose reports are poorly written, have failed to support their determination of value. So it's imperative that your client hire an experienced, accredited business appraiser who focuses on business valuation fulltime and not someone who offers business appraisal services on the side. The business appraisal should conform to the Uniform Standards of Professional Appraisal Practice. Also, make sure that their firm is established and will be around in two to three years if your client's transaction gets audited by the IRS. 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 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. By selecting good counsel, thinking through the long-term considerations of the partnership agreement, and properly documenting their transactions with a business appraisal, FLPs can be an excellent choice for asset protection, dispute resolution, and wealth transfers. **CL**

Notes

1. *Estate of Elsie Church v. United States,* 2000-1 U.S. Tax Case. (CCH) 60,369 (W.D. Tex. 2000)
2. *Baine P. Kerr, et ux. v. Commissioner*, 113 T.C. No. 30 (1999)
3. Kimbell v. U.S., 371 F3d 257 93 5th Cir. (2004)
4. *Kelley v. Commissioner,* 64 TCM 654 (1992)
5. *Estate of Peracchio v. Commissioner,* 86 T.C.M. 412 (2003).
6. Spencer Jefferies, et. al., *Comprehensive Guide for the Valuation of Family Limited Partnerships, 4th ed.,* (Dallas, TX: Partnership Profiles, Inc., 2011), 127-129.