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. Maine’s Uniform Limited Partnership Act of 2007 and the Maine Limited Liability Act allow 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 non-controlling 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.

In almost every IRS challenge to FLPs or LLCs, the case is focused around valuation issues.

Formation and Operation
In the 1990s and 2000s, 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. 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 Maine 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 percent-100 percent) 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 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.

When valuing limited partnership or LLC interests, it contin-
ues to be common practice for many business appraisers simply for lack of control over 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 its 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 non-controlling, 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 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 steps above 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.

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