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The Taxman Cometh

If you are considering a family limited partnership, be mindful that the IRS has its eyes on you.

BY **BRUCE A. JOHNSON**

Family limited partnerships are popular with taxpayers due to their effectiveness in asset protection, dispute resolution, and favorable tax benefits for gifting. The IRS, however, has not been fond of them. In fact, certain IRS officials have reportedly stated off the record that every FLP will be examined. 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?

Hire experienced legal and accounting counsel. The IRS frequently challenges FLPs based on how they were formed and whether the partnership has been operated in accordance with the rules in the partnership agreement. For example, Internal Revenue Code 2036 is an IRS requirement that prohibits combining personal and partnership money. A taxpayer should keep separate checkbooks and follow the legal formalities of the partnership agreement.

Set a clear business purpose for the partnership. In addition to reducing taxes on partnership transfers, FLPs also provide asset protection and management consolidation advantages. In addition, the rules in the partnership agreement set forth what to do in case of disputes. Take the time to think through how you want to handle and resolve conflicts between the partners, who will likely be your children and their spouses. An experienced attorney can help you with this issue when writing the partnership agreement, which can prevent gridlock in the future.

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. Commissioner of Internal Revenue*, the taxpayer lost a significant tax deduction because he failed to have a proper business appraisal, which 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 estate tax plan.

Hire a full-time accredited business appraiser. 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 that you will need if your FLP transaction is audited. When FLPs are litigated, the U.S. Tax Court has been particularly critical of appraisal experts whose reports are not well written and fail to support their determination of value. Hire an experienced, accredited business appraiser who focuses on business valuation full time 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 the firm is established and stable and will be around in two to three years in case the IRS audits your transaction. Appraisers with U.S. Tax Court experience who are accredited by one of the major appraisal organizations tend to be well qualified, but don't be shy to ask for references.

While there is no guarantee that your FLP gift will escape IRS examination (and you cannot buy insurance to protect against the possibility of an audit), following the above steps will help you make good judgments so that you can reap the maximum benefits from your FLP. By selecting good counsel, thinking through the long-term considerations of the partnership agreement, and properly documenting your transactions with a business appraisal, FLPs can be an excellent choice for asset protection, dispute resolution, and wealth transfers. **TBJ**

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