



FLP Audit Triggers

Family Limited Partnerships Raise Red Flags at IRS
By Michael B. Allmon, CPA and Nelson Handy, CPA, Esq.

The application of gift and estate tax laws to family limited partnerships is in many ways unclear, admits Charles Morris, IRS Western Estate and Gift Tax Territory Manager. Morris discussed the IRS perspective on FLPs at a recent Los Angeles Chapter Estate Planning Committee meeting.

A significant reason that the IRS is aggressively attacking the discounts claimed for interests in FLPs is the lack of consistency. Morris questions the fairness of dramatically different tax results among taxpayers who retain similar benefits from like assets based upon the method of holding those assets.

Further, there is an issue of consistency from region to region in the audit of FLP transfers. As a result, the IRS will aggressively review the claims for discounts for transfers of FLP interests so that the rules can become clear and can be applied consistently

Red Flags

Morris cited three red flags that trigger audits of family limited partnerships:

- An FLP lacking a valid planning purpose.
- A managing partner directly benefiting from assets placed in the FLP.
- Overly generous discounts.

Tax Court Decisions

Morris reviewed significant Tax Court decisions that provide guidance on FLPs.

Valid Purpose

Murphy v. Comr—This case established that an FLP has to have a purpose other than tax avoidance. If it exists just to avoid estate taxes, the FLP will be disregarded for estate tax purposes.

Watch Those Controlling Interests

Strangi et al v. Comr—A family member with power of attorney set up an FLP for his invalid father-in-law (Strangi). The FLP was funded with cash and securities. The family corporation was the general partner of the FLP and the son-in-law effectively ran

both entities. Within two months, Strangi died.

The IRS stated that there was no business purpose and therefore the FLP should be disregarded. However, the court noted that the FLP's formation had strictly followed Texas state law for FLPs. So it had to be accepted as such.

The IRS further argued that the formation of the FLP resulted in a gift based on a comparison of the value of the assets placed in the FLP and the value of the FLP interest received. The court held that no gift was made.

The court noted the IRS arguments that Strangi effectively retained control of, and benefit from, the property he contributed to the FLP. Under IRC Sec. 2036, such an arrangement might result in inclusion of all the assets in the taxpayer's estate as a retained interest. But since the IRS did not argue Sec. 2036 earlier in the case, the court did not address that issue. Morris expects there to be further developments in this area.

Appraiser Is Not an Advocate

Knight v. Comr—Here, as with *Strangi*, the court dismissed IRS arguments that a business purpose was required. The IRS also argued that the taxpayer's appraiser applied excessive discounts (the FLP held traded securities and real estate). Here the court agreed with the IRS, saying that the appraiser inappropriately acted as an advocate for the Knights. Hence, the court dropped the discount from 44 percent to 15 percent.

Formation of FLP

Shepherd v. Comr—Shepherd assigned land to an FLP on Day One. His two sons signed the FLP agreement on Day Two. The parties stipulated that the FLP had not been validly formed until Day Two.

The Tax Court ruled that the gifts to the sons did not qualify as gifts of partnership interests, but were indirect gifts of 25 percent interests in the properties to the sons. As a result, the gifts to be valued were fractional interests in real property rather than limited partner-

ship interests. On the evidence presented, the court determined that only a 15 percent discount was applicable to the gifts.

Potential Capital Gains Not Considered

Jones v. Comr—One of the issues presented in this case was whether potential capital gains applicable to appreciated property held in the partnership should be a factor in determining the applicable discounts. The court sided with the IRS and ruled that potential capital gains will not be considered when valuing a limited partnership interest that includes appreciated property.

Burden of Proof on IRS

Dailey v. Comr—The IRS challenged the 40 percent discount taken for an interest in an FLP that held only traded securities. The IRS had admitted that Dailey had "credible evidence" for the discount. The court held that under IRC Sec. 7491, the burden of proof shifts to the IRS whenever the taxpayer produces credible evidence. Morris commented that the IRS learned its lesson and will be more careful when admitting that a taxpayer's evidence is credible.

Risks to Advisers

Morris notes that CPAs, attorneys, appraisers and other advisers may be liable if they assist in the improper reporting of estate and gift taxes. The penalty can be a \$1,000 fine and potential loss of the right to practice before the Internal Revenue Service. ■

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