RINET Company Lawyers Roundtable
Summer 2004

Use of family limited partnerships (FLPs) may reduce a family's estate and gift taxes. When assets are transferred to an FLP by a family member, the valuation of the FLP interests held by the limited partners declines because of the restrictions on their ability to use, sell or transfer their interests. This strategy has often been used to transfer assets to a younger generation while paying low or no taxes.

There are risks and uncertainties associated with this strategy. In 2003's Strangi case, the Internal Revenue Service (IRS) successfully challenged an FLP by arguing that the deceased person had retained control over the underlying property. However, in May 2004, the Fifth U.S. Circuit Court of Appeals apparently reversed that decision in the Kimbell case.

The implications of the Kimbell and Strangi cases were discussed at RINET Company's Semiannual Lawyers Roundtable held on June 22, 2004. What follows are some of the highlights of that discussion, which included 12 of Boston's top attorneys in the area of estate planning, in addition to RINET Company executives. To ensure that the participants spoke freely, none of them are quoted by name below. Their names are listed at the end of this document.

Post-Kimbell guidelines

The Kimbell case provides helpful guidelines for setting up an FLP. As one attorney said, "It is a road map for what to put in your FLP agreement." In particular, the person establishing the FLP should:

- Retain assets sufficient for their support, including their personal residence, outside the FLP.
- Pay their personal expenses and estate taxes using assets outside the FLP.
- Follow the partnership's legal formalities, such as ratable distributions to partners and segregation of partnership and personal accounts.
- Avoid exercising too much personal control ("self-interest") over the assets.
- Be aware of the non-tax benefits of the FLP structure.

However, as one attorney said about Kimbell, "It's a start but it doesn't solve all the problems." For example, Kimbell highlights the need for "valid (non-tax) business reasons for the formation of the partnership." As another attorney said, "Auditors could raise the issue of 'Is there a valid business purpose to create this business entity in the first place?' "

Fifth Circuit vs. First Circuit

The Kimbell decision is binding only in the states of the Fifth Circuit, which are states such as Texas in the south central region of the United States. Moreover, the Fifth Circuit Court has been known as a very taxpayer-friendly court. “Here in the First Circuit, auditors may not feel that Kimbell is the end of the issue,” said one attorney. According to another, “Agents are saying ‘We’ve still got Strangi.’ ”

Rumor has it that Strangi may be settled out of court. If that’s true, it may be a while before more concrete guidance on FLPs comes from the courts.

What recent IRS field audit settlements suggest

Some recent IRS settlements in New England FLP cases suggest that local IRS agents may be:

- Focusing more on the percentage discount taken on the FLP interests than on the underlying valuations of assets.
- Targeting cases using appraisers whose appraisals they consider poorly documented or overly favorable to clients.
- Overburdened with cases, so they’re interested in prompt negotiated settlements.
- More concerned with the FLP’s structure and discounts taken than with the client’s age or health.

Focus on percentage discounts

Some participants said they’ve encountered agents who haven’t challenged the underlying valuation of assets held in an FLP. Rather, they’ve focused on the percentage discount applied to the FLP interests. In a case with primarily marketable securities, the agent started off by saying “I’m not authorized to settle for anything more than 25%.” However, the case was ultimately settled with a 32% discount.

Some participants suggested that taking a discount of 50% on marketable securities is somewhat aggressive and might attract an audit. Among others, 50% seemed to be a common starting point as part of a strategy to negotiate to a lower level from that point.

Focus on specific appraisers

The focus on percentages doesn’t mean that agents aren’t concerned about valuations. Indeed there is anecdotal evidence that agents are targeting clients using appraisers whose appraisals the agents consider poorly documented or overly favorable to clients. “The IRS is auditing cases of specific appraisers,” said one attorney.

Real estate cases

A more complex, two-tier case involved an FLP for a real estate partnership the client had invested in back in the 1970s. Unlike in the marketable securities cases discussed earlier, valuation of the underlying real estate was also an issue. “My first eight months were spent working with the agent on the underlying real estate value,” said the participant. But then the agent moved on. The agent picked on the two-tier discount, but was swayed by the fact that the original real estate partnership dated back more than 20 years. The case was ultimately settled with a percentage discount in the mid-forties for both the top and bottom tiers.

In another pair of real estate cases, the agents also questioned the valuation of the underlying assets. “They compared our real estate versus ‘Class A’ property, which ours was not,” said the attorney. The case settled for a discount of almost 40%.

IRS agents pressed for time

There’s some evidence to suggest that negotiating over percentage discounts is being used as a time-efficient way for agents to wrap up cases. As one participant commented, “I think the whole field audit office is backlogged.”

Concern about how the FLP is run

One participant expressed surprise that “The agent was not hung up on the age or health of the client.” Rather, agents seem more concerned about whether the partnership agreement was well drafted and administered according to those terms. In that case, it helped that the client and the FLP had kept separate sets of accounting records. “The trouble I’ve seen has been where they haven’t adhered to the form they’ve adopted and instead they’ve treated the FLP as just another bank account,” added the participant. This is consistent with the Kimbell case.

One agent seemed to fish for evidence about whether the FLP had been established solely to evade taxes. He asked whether the tax advantages of the FLP had been discussed with the client. The client’s representative was careful to note that “I also pointed out the non-tax attributes.”

Conclusion

In conclusion, the experience of Lawyers Roundtable participants shows that FLPs may hold up in court if they are properly structured, the terms of the FLP are adhered to, and the appraisals of the assets are reasonable. The guidelines for FLPs have firmed somewhat thanks to the Kimbell case. However, there are still many aspects that have yet to be tested in New England courts or indeed anywhere in the United States.

The opinions expressed in this bulletin are intended for general guidance only. They are not necessarily the opinions of all participants in the Lawyers Roundtable. They are not intended as recommendations for specific situations. As always, readers should consult a qualified adviser for specific tax and legal advice.

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