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TITLE: Family Limited Partnerships: A Practical Guide to Fighting Legal Pitfalls

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Family Limited Partnerships:
A Practical Guide to
Fighting Legal Pitfalls

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American Bar Association
Joint Fall Meeting
Tax Litigation and Controversy Committee

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I. Consider Appropriateness of Partnership

1. Keep your potential future audience in mind

- Consider what you write – email, memo to file regarding reasons for partnership formation, time records (for attorneys/accountants), letters, etc.
- The IRS, a judge, or even a jury may eventually be reviewing documents written during the planning stages
- Consider and document all substantive non-transfer tax reasons that fit the situation; avoid template laundry list

I. Consider Appropriateness of Partnership

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2. Evaluate potential assets

- "Risky" assets should be segregated from other assets
- No retirement plans, IRAs, etc.
- No stock in S-corporations
- Contribution of stock in a closely-held corporation requires analysis of § 2036(b) of Internal Revenue Code

I. Consider Appropriateness of Partnership

2. Evaluate potential assets (cont'd.)

- No personal use assets
- Partners should retain enough assets outside Partnership to support lifestyle
- If assets that are hard to value are contributed to the Partnership, partners will need appraisals to calculate initial ownership interests in Partnership
- Transfer restrictions on any assets need to be reviewed and appropriate consents obtained

I. Consider Appropriateness of Partnership

2. Evaluate potential assets (cont'd.)

- If real estate or other non-liquid assets will be contributed to the Partnership, the Partnership will need enough cash to maintain those assets
- Contribution of assets subject to debt (margin debt, mortgages, etc.) requires consideration of income tax issues
- Investment company rules should be analyzed

I. Consider Appropriateness of Partnership

3. Evaluate potential partners

- Other family members? LLC? Trusts?
- What role will other partners play in partnership management?
- Partnership management will owe duties to other partners

I. Consider Appropriateness of Partnership

3. Evaluate potential partners (cont'd.)

- Consider health of partners
- Meaningful contributions by partners

I. Consider Appropriateness of Partnership

4. Engage/consult with advisors who have experience in this area

- Avoid “kit partnerships”
- Any attorney/accountant who will be involved with the Partnership should be consulted sooner rather than later

II. Partnership Formation

1. Counsel Partners to discuss following partnership terms:

- management structure
- compensation to be paid to managers
- investment policy
- expected distributions
- transfer restrictions on partnership interests
- term of Partnership
- tructuring for and consequences of annual exclusion gifts

II. Partnership Formation

2. Consider separate counsel for some (or all) participants

- Discuss terms of Partnership Agreement
- Partners should read the Partnership Agreement

II. Partnership Formation

3. Ensure that Schedules to Partnership Agreement are complete

- Partnership Agreement should accurately set forth assets contributed to Partnership and ownership interests in Partnership

II. Partnership Formation

4. Prepare deeds and transfer documents prior to formation date

- Have parties sign transfer documents at the same time as Partnership Agreement and related formation documents
- Ensure that partners own assets to be contributed before Partnership is created
- Ensure transfer of title of all assets to Partnership before making gifts of partnership interests

II. Partnership Formation

5. File for Employer Identification Number (EIN) soon

- Upon receipt of Certificate of Limited Partnership

II. Partnership Formation

6. Create Partnership bank/brokerage accounts in a timely manner

II. Partnership Formation

7. Engage a good partnership accountant

- accounting issues could make or break court's view of whether to respect existence of Partnership
- Section 754 elections
- protective claims
- audit procedures, etc.
- initial ownership interests should not change in the absence of additional capital contributions, redemptions, sales, etc.

II. Partnership Formation

8. Ensure that partners receive interests in the Partnership in proportion to the fair market value of the assets contributed by each to the Partnership

- Correctly reflect the fair market value of the assets contributed in the respective partner’s capital account

II. Partnership Formation

9. Consider amortizing partnership set-up fees

II. Partnership Formation

10. If necessary, amend Partnership percentages as quickly as possible after formation

- If assets were contributed to the Partnership but the value was not known on the date of formation (such as is likely to be the case with hard-to-value assets), amend the percentages as soon as information on all contributed assets becomes available

II. Partnership Formation

11. Be prepared to produce documents in your file to the IRS, if necessary

- The best evidence of formation rationale often comes from the correspondence prepared in connection with the transaction. Keep your potential audience in mind
- Assertion of privilege may lead to negative inferences

III. Partnership Maintenance

1. File tax returns for each year in existence

III. Partnership Maintenance

2. File any annual/bi-annual registration statements required by relevant state authorities

III. Partnership Maintenance

3. Comply with terms of Partnership Agreement

- Are periodic meetings required? At any meeting, consider taking minutes, even if not required by Partnership Agreement
- Are annual statements (other than tax returns) required?
- Are annual distributions required?
- Are payments on preferred interests required?

III. Partnership Maintenance

4. Keep the charity involved

- If a charity has an interest in the Partnership, keep the charity involved in the Partnership for as long as practicable

III. Partnership Maintenance

5. Comply with loan terms, if loans are made

- Beware lending from the Partnership to family members
- Any loans made by the Partnership should comply with the terms of the Partnership Agreement
- Any loans should be properly documented
- Loan terms should be reasonable
- Payments should be made timely

III. Partnership Maintenance

6. Make any distributions pro rata

- Make sure that all distributions are pro rata (proportionate to percentage interests in the Partnership)
- If you discover a non-pro rata distribution, immediately do a “make-up” distribution, with interest

III. Partnership Maintenance

7. If a partner dies, do not write checks out of the Partnership's accounts to creditors of the deceased partner

III. Partnership Maintenance

8. If a partner dies or transfers an interest in the Partnership, consider whether to make a Section 754 election

III. Partnership Maintenance

9. **If a partner dies and the partner's estate needs funds, consider having the estate sell a partnership interest or borrow money, rather than making distributions from the Partnership**

III. Partnership Maintenance

10. Avoid multiple transactions between partners and Partnership

- loans
- redemptions
- non-regular distributions
- non-pro rata distributions

III. Partnership Maintenance

11. Review the non-tax reasons you stated for forming the Partnership and follow them

- involvement of family members
- gifting
- asset management

IV. Transfer Tax Reporting

1. **Obtain independent appraisal from qualified appraiser**

IV. Transfer Tax Reporting

2. Review appraisal closely for facts

- Distribution policy
- Partnership terms
- Assets
- Cash flow

IV. Transfer Tax Reporting

3. Try to live by factual information provided to appraiser

- Cash flow, distribution policy, etc.

IV. Transfer Tax Reporting

4. Beware of rounding

V. Audit

1. Consider bringing in litigation counsel

V. Audit

2. **Determine whether a document destruction policy exists; if so, suspend**

V. Audit

3. Consider the burden of proof

- I.R.C. § 7491
  - maintain required records
  - comply with reasonable requests for documents, information, and interviews
  - not a partnership, corporation, or trust

V. Audit

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4. Consider the impact of privileges

- Attorney-client privilege
- Work-product doctrine
- Tax Practitioner’s Privilege – I.R.C. § 7525
- Waiver, generally
- Subject matter waiver

V. Audit

5. Consider whether production of privileged information may help your case

- Beware subject matter waiver

V. Audit

6. Provide responses to the IRS that are true and correct, to the best of your knowledge

- Be precise

V. Audit

7. Keep in mind that anything stated or written at this stage can be treated as an admission

- Anything written to the appraiser or any expert is discoverable

V. Audit

8. Produce responsive documents in your possession, custody, or control

V. Audit

9. Keep careful track of every document and electronic file produced to the IRS

- Bates-label every document, and send a copy of the Bates-labeled copy to the IRS

V. Audit

10. Understand the IRS's broad subpoena power

- IRC § 7602(a)
- May examine or summon a laundry list of items and people
- For the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax"
- Subpoena power is subject to privileges

V. Audit

11. Go easy on process and tough on substance

V. Audit

12. File protective claims if necessary

V. Audit

13. Keep Partnership in place

V. Audit

14. If you're in an audit of an estate, refrain from distributing Partnership interests held in the estate to the beneficiaries

V. Audit

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15. If you're in an audit of an estate, save any estate audit expenses for deduction at the conclusion of the matter – on Form 4421

- Consider not taking expenses as deductions on estate's 1041s
- Advise Executor to consider keeping track of time spent on estate matters

V. Audit

16. Treat informal interviews as depositions

- Prepare witnesses as if for a deposition
- Have a court reporter present
- Conduct interview at advisor’s office, rather than client’s office

V. Audit

17. Treat a protest like a brief

Structures to Avoid IRC 2036(a)(1)

IRC 2036(a)(1) may be avoided by one of the three courses of action:

- The taxpayer transfers limited partnership interests during lifetime (either for adequate and full consideration, or if by gift, more than 3 years before the taxpayer's death); or
- If the taxpayer does not transfer partnership interests during the taxpayer's lifetime, the taxpayer demonstrates that there is at least one substantial non-tax reason to establish the partnership and the capital accounts of the partnership do reflect interests proportional to the contributed property; or
- If the taxpayer does not do either of the courses of action described above, the taxpayer and the partnership have practices that demonstrate that an implied or actual agreement to retain possession or enjoyment of the income of the contributed assets does not exist.

Eastland, Stacy, Leveraged Gifting Transactions in the New Millennium©, Chapter 4.1, State Bar of Texas, 12th Annual Advances Estate Planning Strategies Course (2006)

Planning to Avoid a Potential IRC 2036(a)(2) Attack

- Taxpayers should consider adopting a strategy of selling partnership interests (perhaps to defective grantor trusts) in exchange for a note or other full consideration.
- Normal partnership fiduciary duties should be affirmed in the partnership agreement.
- If the donor partner is going to retain a distribution power, consideration should be given to having the distribution power of the managing partner limited to a standard that may be enforced by a court. See Rev. Rul 73-143.
- If a donor partner wishes to indirectly retain a distribution power and have that power "free" of an enforceable standard, consideration should be given to utilizing the safe harbor under Rev. Rul. 95-98.
- If a donor partner wishes to retain the distribution power and have that power "free" of an enforceable standard, and does not wish to create a trust with an independent trustee, consideration should be given to utilizing the safe harbor under Rev. Rul. 81-15.

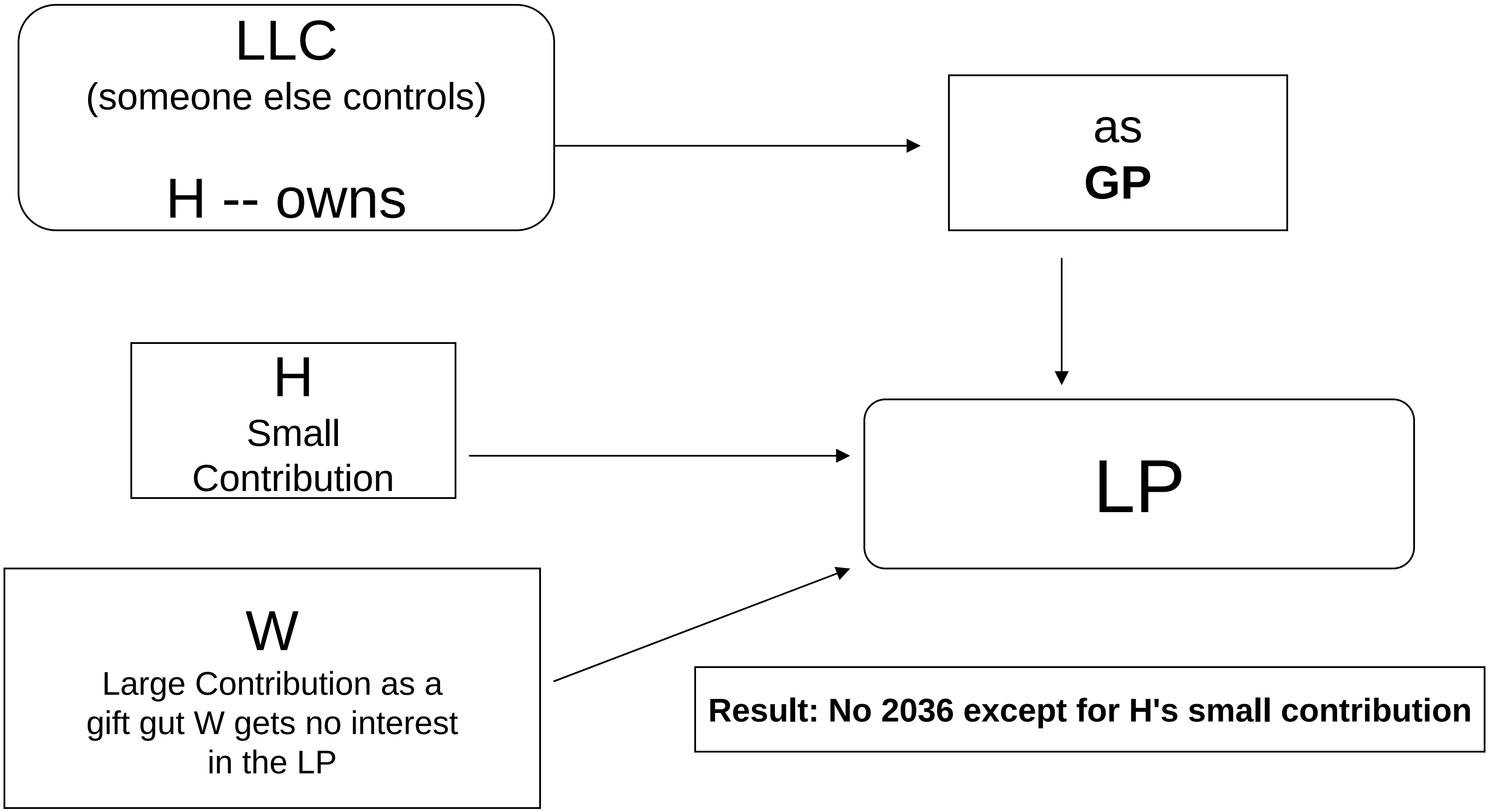
Eastland, Stacy, Leveraged Gifting Transactions in the New Millennium©, Chapter 4.1, State Bar of Texas, 12th Annual Advances Estate Planning Strategies Course (2006)

Planning to Avoid Owning Any Partnership Interest

- Assuming sale is for adequate and full consideration (of if not, the sale occurs more than three years before taxpayer's death) IRC Section 2036 (a)(1) will not apply to transferred partnership interests.
- Valuation principles of Rev. Rul. 93-12 will apply.
- Growth of partnership interests above "interest carry" will not be subject to estate tax.
- Congress could change law with respect to partnership discounts in the future. Selling now locks in current law with respect to discounts.
- Taxpayer generally has the ability to access cash flow for consumption needs.
- Flexible arrangement that can be modified to changed circumstances.
- A note is a more favorable asset than partnership interests for testamentary charitable giving.

Eastland, Stacy, Leveraged Gifting Transactions in the New Millennium©, Chapter 4.1, State Bar of Texas, 12th Annual Advances Estate Planning Strategies Course (2006)

Avoiding 2036



Authors' depiction of planning tools proposed by Mitchell Gans & Jonathan Blattmacher in Family Limited Partnership's Formation: Dueling Dicta, Capital University Law Review 2006; http://ssrn.com/abstract=921641.

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