FLPs - Don't Leave Home Without One (But Leave Your Home Outside of it)

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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 a template laundry list

I. Consider Appropriateness of Partnership

2. Consider whether clients are ready for a partnership

- Sophistication of clients
- Willingness to comply with Partnership Agreement's terms
- Willingness to pay professional fees over time

I. Consider Appropriateness of Partnership

3. Evaluate potential assets

- "Risky" assets should be segregated from other assets
- No retirement plans, IRAs, etc.
- No stock in S-corporations
- Contributions of stock in closely-held corporations require analysis of § 2036(b)

I. Consider Appropriateness of Partnership

3. Evaluate potential assets (cont'd)

- Refrain from contributing personal use assets
- Retain enough assets outside Partnership to support lifestyle
- Secure appraisals of hard to value assets
- Review transfer restrictions on assets to be contributed; obtain appropriate consents, if necessary

I. Consider Appropriateness of Partnership

3. Evaluate potential assets (cont'd)

- Ensure sufficient cash is contributed to the Partnership to fund maintentance of Partnership's real estate or other non-liquid assets
- Consider income tax issues related to contribution of assets subject to debt (margin debt, mortgages, etc.)
- Analyze investment company rules

I. Consider Appropriateness of Partnership

4. Evaluate potential partners

- Consider whom to involve
- Consider health of partners
- Encourage meaningful contributions by partners

I. Consider Appropriateness of Partnership

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

- Involve attorney/accountant sooner rather than later
- Avoid “kit partnerships”

II. Partnership Formation

1. **Consider separate counsel for some (or all) participants**
   - Discuss terms of Partnership Agreement
   - Read and understand terms of Partnership Agreement

II. Partnership Formation

2. 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

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

- Ensure transfer of title of all assets to Partnership
- 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

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

- Factors to consider
  - Changes in ownership interests
  - I.R.C. Section 754 elections
  - Protective claims
  - Audit procedures

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

- reimbursement to partner who initially paid

II. Partnership Formation

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

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
- Assertion of privilege may lead to negative inferences

III. Partnership Maintenance

1. **Consider filing 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. 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

5. 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, consider a “make-up” distribution, perhaps with interest

III. Partnership Maintenance

6. Refrain from use of Partnership assets for Partners' personal obligations

- Personal use assets
- Partners' expenses
- Estate's needs

III. Partnership Maintenance

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

III. Partnership Maintenance

8. Avoid multiple transactions between partners and Partnership

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

III. Partnership Maintenance

9. Review non-tax reasons stated for forming Partnership and follow them

- involvement of family members
- asset management

IV. Transfers of Partnership Interests

1. Generally

- Ensure books and records of Partnership are in order
- Consider whether transfer triggers any rights of first refusal
- Keep track of changes in partnership interests
- Consider restating schedule or exhibit to Partnership Agreement that indicates ownership interests
- Consider keeping historical spreadsheet showing changes at each transaction

IV. Transfers of Partnership Interests

1. Generally (cont'd)

- Document the transfer, to be executed by transferor and transferee
- Date the transfer document – effective date vs. date signed
- Review Partnership Agreement to determine how interest is to be valued
- Ensure that changes in percentage interests are reflected in books and records of Partnership
- Ensure that the Certificate of Limited Partnership is amended, if necessary

IV. Transfers of Partnership Interests

2. By Gift or Sale

- Review Partnership Agreement to ensure compliance with terms
- Refrain from gift planning until Partnership is formed and operating
- Consider income tax issues (on sale)

IV. Transfers of Partnership Interests

3. At Death

- Review Partnership Agreement to determine character of interest passing – general partnership interest, limited partnership interest, assignee interest
- Review transfer to determine whether a lapse occurs under Chapter 14
- Review Partnership Agreement to determine whether Executor steps into the partnership shoes of the Decedent partner

IV. Transfers of Partnership Interests

3. At Death (cont'd)

- Consider maintaining the interest in the hands of the Executor, subject to estate administration, until a closing letter is received from the IRS
- Once IRS closing letter is received, document the transfer, to be executed by executor and beneficiary

IV. Transfers of Partnership Interests

4. By Redemption

- Review Partnership Agreement to ensure that Partnership is not prohibited from redeeming the interest
- Document the redemption, to be executed by Partnership management and the transferring partner
- Ensure that books and records of Partnership reflect decrease to transferring partner's interest and corresponding proportionate increase to all remaining partners' interests

V. Transfer Tax Reporting

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

V. Transfer Tax Reporting

2. Attorney/Appraiser Interaction

- High level of interdependence:
  - Bad legal facts + Good appraisal = Bad result
  - Good legal facts + Bad appraisal = Bad result
  - Both scenarios = Unhappy client

V. Transfer Tax Reporting

3. **Confirm with the appraiser the interest to be valued**

V. Transfer Tax Reporting

4. Consider whether to aggregate interests

- Interests held in trust may be valued separately

V. Transfer Tax Reporting

5. Provide access to client and assistance in due diligence process

- Will ensure that information is accurately conveyed
- May provide unique knowledge of family issues that can impact governance

V. Transfer Tax Reporting

6. Defensibility of valuation reports

- Well documented
- Proper due diligence
- Thorough understanding of empirical data
- Relevant comparative factors
- Readily understood

V. Transfer Tax Reporting

7. Review appraisal closely for facts

- Distribution policy
- Partnership terms
- Assets
- Cash flow

V. Transfer Tax Reporting

8. Try to live by factual information provided to appraiser

- Cash flow, distribution policy, etc.

V. Transfer Tax Reporting

9. Beware of rounding on appraisals and tax returns

V. Transfer Tax Reporting

10. IRS Settlement Guidelines

- Goal: Consistency across different jurisdictions
- Issues addressed:
  - Proper discounts on different asset classes
  - Inclusion of 2036 or 2038 transfers in gross estate
  - Determination of indirect gifts of assets
  - Applicability of accuracy-related penalties

VI. Audit

1. Consider bringing in litigation counsel

VI. Audit

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

VI. Audit

3. Consider the burden of proof

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

VI. Audit

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

VI. Audit

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

- Beware subject matter waiver

VI. Audit

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

- Be precise

VI. 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
- Educate your appraiser
- Beware spoliation of evidence

VI. Audit

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

VI. Audit

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

- Bates-label documents; send copy to the IRS

VI. 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

VI. Audit

11. Go easy on process and tough on substance

VI. Audit

12. File protective claims if necessary

VI. Audit

13. Keep Partnership in place

VI. Audit

14. If you're in an audit of an estate . . .

- Refrain from distributing Partnership interests held in the estate to the beneficiaries
- 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

VI. Audit

15. 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

VI. Audit

16. Treat a protest like a brief

VII. Relevant Cases

Valuation:	***Estate of Caracci v. Comm'r*, 118 T.C. 379 (2002)**
Valuation:	***Estate of Caracci v. Comm'r*, 456 F.3d 444 (5th Cir. 2006)**
2036:	***Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005)**
Promissory Notes:	***Estate of Graegin v. Comm'r*, 56 T.C.M. (CCH) 387 (1988)**
Recycling of Value:	***Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002)**
2036:	***Kimbell v. U.S.*, 244 F. Supp. 2d 700 (N.D. Tex. 2003)**
2036:	***Kimbell v. U.S.*, 371 F.3d 257 (5thCir. 2004)**
2036:	***Korby v. Comm'r*, 89 T.C.M.(CCH) 1150 (2005)**
Valuation:	***Lappo v. Comm'r*, 86 T.C.M. (CCH) 333 (2003)**
Valuation:	***McCord et al. v. Comm'r*, 120 T.C. 358 (2003)**
Defined Value Transaction:	***Succession of McCord et al. v. Comm'r*, 461 F.3d 614 (5th Cir. 2006)**
Valuation:	***Peracchio v. Comm'r*, 86 T.C.M. (CCH) 412 (2003)**
2036:	***Estate of Rosen v. Comm'r*, 91 T.C.M. (CCH) 1220 (2006)**
2036:	***Schutt v. Comm'r*, 89 T.C.M. (CCH) 1353 (2005)**
Indirect Gift:	***Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2006)**
Indirect Gift:	***Senda v. Comm'r*, 433 F.3d 1044 (8th Cir. 2006)**
Indirect Gift:	***Shepherd v. Comm'r*, 115 T.C.No. 30 (2000)**
Indirect Gift:	***Shepherd v. Comm'r*, 283 F.3d 1258 (11th Cir. 2002)**
2036:	***Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003)**
2036:	***Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000)**
2036:	***Estate of Strangi v. Comm'r*, 293 F.3d 279 (5th Cir. 2002)**
2036:	***Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003)**
2036:	***Estate of Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005)**
2036:	***Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002)**
2036:	***Turner v. Comm'r (Estate of Thompson)*, 282 F.3d 367 (3rd Cir. 2004)**

IRS Circular 230 Disclaimer: Under applicable Treasury regulations, this advice is not intended or written to be used, and cannot be used, for the purpose of avoiding any penalties. If you would like an opinion upon which you can rely to avoid penalties, please contact the sender to discuss.

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