

Family Limited Partnerships: Guidelines for Success

By Julie T. Brown



For the past fifteen to twenty years or so, a popular business and estate planning technique

has been the use of family limited partnerships ("FLIPS") for the purpose of management of real estate and investment assets. They have also been used as an estate planning technique, allowing families to transfer wealth from one generation to the next. For nearly as long, the IRS has tried a number of theories to attack the tax and financial planning benefits of FLIPS. The question is whether FLIPS will survive the continued intense scrutiny of the IRS in light of recent cases.

By way of background, a FLIP is simply a limited partnership created by family members. The family members contribute property, including stock, bonds, cash or real estate, and in return, receive partnership interests. The FLIP, just as a general partnership, is managed by the general partners. The limited partners are essentially passive investors with few, if any, management rights. Similar to general partnerships, the general partners of a limited partnership remain liable for the debts and liabilities of the partnership, unless the partnership is registered with the Missouri Secretary of State as a "Registered Limited Liability Limited Partnership." This registration will afford limited liability to all of the limited partnership's partners, including the general partners.

There are numerous tax and non-tax reasons for establishing FLIPS. These reasons include (i) establishing a method by which annual gifts may be made without dividing a particular asset, (ii) continuing the ownership and operation of family assets, (iii) restricting the right of non-family members to acquire interests in family assets, (iv) providing protection from creditors of family members and (v) providing flexibility and continuity of business planning.

The IRS has attacked the use of the FLIP as an estate planning technique on several grounds. In recent years, the IRS has scored some key victories using IRC §2036. In several cases, the IRS has persuaded the Tax Court to disregard the FLIP, forcing the taxpayer to include the partnership's assets in the donor's gross estate so that the donor or his estate loses the benefit of valuation discounts. The cases tend to focus on whether property was transferred legitimately and at arms length, and whether the transfer constitutes a "recycling" of value. These cases provide us with guidance regarding the structure of FLIPS. To protect against a Section 2036 attack, FLIPS should adopt the following guidelines and incorporate them into the operation of the FLIP:

1. The partners should respect the separate existence of the partnership. If a distribution is to be made out of the partnership, it should be made pro rata to all the partners in accordance with their respective ownership percentages. Disproportionate distributions from a FLIP will be troublesome to the IRS, and ultimately, to the partners. Also, distributions

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Will FLIPS survive intense IRS scrutiny?

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Tax Corner: Revised IRS Circular 230

The new rules apply to tax professionals

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By Frank C. Carnahan



On June 20, 2005, the IRS issued Circular 230, *Rules of Practice before the IRS*, containing new rules affecting how attorneys, tax professionals, and others communicate with their clients in written advice on tax issues, including e-mails, faxes, and letters, and imposing significant penalties for non-compliance. The new rules attack “boiler-plate opinions” used by promoters who sell “abusive tax shelters” in order for their clients to escape tax penalties of 20 percent or more by claiming they “reasonably” and “in good faith” relied on the tax opinion.

While designed to address those types of abuses, the new rules apply to tax professionals who give advice on many common, accepted transactions. Practitioners must either:

1. Provide a comprehensive opinion that considers and discusses (i) all relevant

facts and applicable law, (ii) the relationship between the facts and the law, (iii) a conclusion as to the legal consequences of each tax issue, and (iv) the likelihood that the taxpayer will prevail if the IRS challenges the transactions; or

2. Include a disclaimer stating, for example, “This written advice is not intended or written to be and cannot be used by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer.”

The cost of preparing the required comprehensive opinion may be substantial and will often not be justified, so disclaimers will often be used to comply with the new rules. You may have already noticed such a disclaimer in our communications to you, but the disclaimer required by the new rule does not decrease the quality of our service and the advice you expect from us. Do not hesitate to ask any of our tax attorneys any questions you might have about the new rules. ■

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should be made on an established periodic basis. It would appear that pro rata distributions, while necessary, are not enough if they are made irregularly in response to the perceived cash needs of the donor.

2. The partners should act in a manner that is consistent with the partnership agreement. The partnership should not pay an individual partner's bills, nor should an individual partner utilize partnership property for personal reasons. The individual partners should also not commingle their personal assets with FLIP assets.

3. Sound accounting principles and practices must be maintained.

4. FLIP documents should expressly hold the general partner or manager to a fiduciary standard in their dealings with the FLIP.

5. Establish the FLIP as soon as possible. The partnership should be formed while the donor has a reasonable life expectancy. Don't wait to make it a deathbed partnership.

6. It is likely more advantageous to fund the partnership with capital contributions of

assets by each of the partners to constitute a “pooling” of family assets.

7. The partnership should be established and continued for a valid business purpose, which should be documented in the limited partnership agreement. RUN THE PARTNERSHIP LIKE A BUSINESS.

8. The General Partners should maintain excellent partnership records, including records of annual partnership meetings, income tax returns, partnership tax returns and valid assignments of partnership assets to the partnership.

9. The IRS seems to be interested in whether a FLIP is continued after the death of a donor decedent.

10. The IRS will look at the proximity of gifts in partnership interests relative to a decedent's death. In other words, was the partnership established, or were gifts made, in anticipation of a decedent's death?

11. The IRS looks askance at the transfer of a majority of a decedent's assets to a FLIP. We would recommend staying away from conveying personal assets, such as residences, cars and vacation homes to a FLIP.

12. The limited partners or the members should have the right to convey their partnership or membership interest. If a limited partner does not have the right to sell or assign his interests, it may not be a “present gift” and therefore, the annual gift tax exclusion may not be available. However, a limited partnership can place restrictions on the right of transfer - for instance, a right of first refusal in the partnership and other partners.

When structured properly, Family Limited Partnerships offer an excellent vehicle for owning and managing of assets, especially investment assets, allowing younger generations to become exposed to good stewardship and growth of family wealth, while yet protecting younger generations from themselves, divorce, and creditors, as well as providing valuable estate planning technique. However, care should be taken in the structure and operation of the FLIP to avoid an IRS attack. ■

Like Kind Exchanges Between Related Parties

*Special rules
apply when
related parties
exchange
property
between
themselves*

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By William E. Evans

In general, Section 1031 of the Internal Revenue Code (the "Code") allows the deferral of gain recognition on the disposition of real and personal property if the taxpayer replaces the disposed property with property of "like kind." The provisions of Section 1031 can be complicated and confusing, but this deferral of gain feature is often used, especially with respect to real estate, mainly because the definition of "like kind" real estate is very broad; i.e., improved property is like kind to unimproved property.

In 1989, Subsection (f) was added providing special rules relating to exchanges between "related parties." "Related parties" include family members and entities where the taxpayer owns fifty percent or more of the entity. Generally, if related parties exchange property between themselves, each party must hold the property received in the exchange for a period of two years before disposing of it in a taxable transaction. This Subsection (f) was designed to prevent "basis shifting" among related taxpayers. In a Section 1031 exchange, a taxpayer receives a carryover basis in the replacement property equal to what he had in the relinquished property. For example, if a taxpayer wants to sell his low basis property, absent Section 1031(f), the taxpayer could exchange his low basis property for his spouse's high basis property. The spouse could then sell taxpayer's property for little or no gain because of the carryover basis received by the spouse on the spouse's replacement

property received in the exchange. Section 1031(f) prohibits this by requiring both taxpayer and spouse to hold the properties for two years.

A more likely scenario that is common today involves a taxpayer with two or more related entities owning real estate. As it is unlikely that two taxpayers will have property that the other wants, exchanges usually involve intermediaries who, under the deferred exchanges rules of Section 1031, coordinate the exchange with a third party buyer. In seeking replacement property, a taxpayer will often designate property owned by a related party. The common misconception made here is that the acquisition of replacement property from a related party will qualify for Section 1031 treatment so long as the taxpayer holds the replacement property for two years. Nothing could be further from the truth. The IRS has taken the position that you cannot acquire replacement property from a related taxpayer in a Section 1031 exchange. This position has been recently adopted by the Tax Court this year in *Teruya Brothers, Ltd. v. Commissioner*. The IRS and the Tax Court now take the position that, generally speaking, you cannot acquire replacement property from a related taxpayer and still qualify for tax deferral under Section 1031 because one of the related parties is "cashing out" in the exchange. There are some exceptions to this general rule that we believe apply under certain circumstances. If you are contemplating a Section 1031 exchange involving a related taxpayer, you should use extreme caution and consult with your tax professional to make sure the exchange qualifies for tax deferral under the Code. ■

IRS Reminder: Teacher Deduction

By Frank C. Carnahan

A deduction from adjusted gross income for 2005 of up to \$250 for qualified out-of-pocket expenses for purchases of books and classroom supplies is available to teachers, instructors, counselors, principals or aides in public or private elementary or secondary schools who work at least 900 hours during a school year. This deduction is available whether or not the taxpayer itemizes

deductions on Schedule A. The IRS suggests keeping records of qualifying expenses noting the date, amount and purpose of each purchase to document the deduction and help prevent a missed deduction at tax time. For more information call the IRS Tele-Tax system toll-free at 1-800-829-4477 and listen to Topic 458. ■



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Special Recognition to...



Julie T. Brown., for her service as Chair of the Community Foundation of the Ozarks Board of Directors for 2004-2005. Under Julie's leadership, the CFO completed one of the most successful years in its 32-year history. Julie helped lead the Foundation through a record-breaking year for new funds, demonstrated by a growth in over \$85

million in assets and the establishment of 149 new funds. During the 2004-2005 fiscal year, \$4.8 million in grants and fund distributions were awarded, the highest annual total in the Foundation's history. Julie's devotion towards community activities have also included the Discovery Center, the Lost & Found, the Boys and Girls Club, and the Hickory Hills PTA. In 2001, Julie was recognized by the Springfield Business Journal with their "40 Under 40" award, for her outstanding contribution to the community as well as her profession.



Thomas D. Peebles, Jr., on his election as Chairman of the Board of Directors for the Community Foundation of the Ozarks for 2005-2006. Tom has served on the Board since 2001 and has been part of the Executive Committee since June 2003. He has also served as the chair of the

Acceptance/Legal Committee. Tom has devoted an extensive amount of his time to civic and charitable activities in the Springfield area. He has been involved or is currently involved with the Foundation for Springfield Public Schools, the Springfield-Greene County Library Foundation, the History Museum of the Ozarks, the Hospice Foundation of Southwest Missouri, and the Child Advocacy Council. Tom was recognized as one of ten "Volunteers of the Year" as part of the 2004 Gift of Time Awards sponsored by the Council of Churches of the Ozarks.

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