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TAX PRACTICE

CORNER

FLP's That Flop

In several recent cases, the IRS successfully challenged attempts to exclude from taxable estates assets transferred to family limited partnerships (FLPs, or "flips") in which a decedent had retained the right to enjoy the property or income from it.

Besides reducing estate taxes, purposes of FLPs include liability protection and asset management. Usually, a parent transfers assets to a FLP in return for ownership of interests. The parent then gifts interests in the FLP to one or more heirs, discounting the gifts' values to reflect a lack of marketability and their minority interest. But under IRC § 2036(a), if the transfer is for less than full and adequate consideration in a bona fide sale and the decedent has implicitly or explicitly retained possession or enjoyment of the transferred property or the right to income from it, the property's value is included in the estate.

In *Estate of Concetta H. Rector et al. v. Commissioner*, TC Memo 2007-367, the taxpayer petitioned the Tax Court to redetermine an IRS-assessed estate tax deficiency of more than $1.6 million and accuracy-related penalty of nearly $93,000. The estate unsuccessfully argued that the decedent had not retained enjoyment of FLP assets or, alternately, that her transfer of assets to the FLP was a bona fide sale.

SALE NOT IN GOOD FAITH

Treas. Reg. § 20.2043-1(a) provides that a bona fide sale must have been made in good faith, which the court noted previous cases have interpreted as reflecting a legitimate and significant nontax business purpose. The taxpayer, however, had no business plan, no independent counsel, no financial statements or annual accounting, no board meetings and no other businesslike activity. The court also noted that the FLP was not even funded for the first three months after its formation.

The estate claimed that it formed the FLP to save on estate taxes, to diversify assets was ever made and that the ownership and management of the assets didn't change after the transfer. Additionally, because the transfer awarded the decedent a partial general partner interest, she effectively received no protection from creditors. This left estate tax savings as the only remaining purpose for the FLP, which the court determined was not a nontax business purpose.

GRANTOR RETAINED RIGHTS

As for a retained enjoyment of property or its income, the Tax Court found that the taxpayer had transferred substantially all her assets into the FLP. Because she primarily used the assets for her personal benefit and paid personal expenses directly from the FLP, the Tax Court said that she personally retained possession of them.

The Tax Court frequently cited *Estate of Bigelow v. Commissioner* (100 AFTR2d 2007-6016), as well as TC Memo 2006-115 (*Rosen*), TC Memo 2003-145 (*Strangi*) and other cases.

Bigelow, decided three months earlier by the Ninth Circuit, involved similar facts. Again, the FLP paid the decedent's bills, FLP property secured personal debt, and most assets were transferred by the decedent to the FLP. In both *Bigelow* and *Rector*, the personal expenses of the grantors exceeded their retained assets, and they had to use the income from the FLP to survive, proving to the courts that no bona fide transfer had occurred. In neither case was a valid business purpose proved nor any businesslike proceedings followed.

TIPS FOR FLPS

Here, then, are some steps for FLPs to take or avoid to help protect themselves from IRS challenge:

- Document a valid nontax business purpose for the transfer, such as liability protection or diversification, and follow through on it.

- Do not provide the grantor with a general partnership interest.

- Hold annual discussions with other partners on investment performance and other business matters of the FLP.

- Disclose financial information yearly to all partners in a timely manner.

- Treat the FLP as a separate entity from the grantor by maintaining separate checking accounts, making sure assets are properly titled, and not commingling funds.

- Obtain outside counsel to establish and monitor compliance with the FLP document and state law.

- Make sure that the grantor retains enough personal assets to live on, without using FLP assets or income to pay for basic needs.

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*By **Bob Jennings**, CPA, CFP, CITP, president of Jennings Advisory Group LLC of Clarksville, Ind., and a frequent writer and CPE speaker on tax topics. His e-mail address is taxspeaker@gmail.com.*