Avoiding IRS Attacks on FLPs and LLCs

By Dennis F. Gorman, Esq., CPA

The IRS has just issued some appeals-settlement guidelines, which taxpayers can use to properly set up and run Family Limited Partnerships and Limited Liability Companies in order to achieve estate and gift tax discounts and savings. The new guidelines are part of an ongoing attack by the IRS on aggressive use of FLPs and LLCs by taxpayers. Basically, you need to address three issues when employing FLPs and LLCs in estate planning. They are:

- Avoid taking excessive discounts for minority interest, lack of control and/or lack of marketability when gifting FLP or LLC shares to your children. Case law over the last several years supports a discount of 30% to 40%, depending on various factors, including the nature of the assets held in the FLP or LLC. However, if you claim a discount that exceeds 40%, you would likely face IRS scrutiny.
- The IRS has the ability to essentially "call back" into your taxable estate previous lifetime transfers of percentage interests in FLPs and LLCs, when you have retained too much control or use of the entity.
- The IRS has been principally focusing on the following fact scenarios, with which the agency has been successful in the courts:
- The taxpayer fails to keep independent accounting records for the operation of the FLP or LLC.
- The taxpayer transfers either all or substantially all of his or her assets to an FLP or LLC, leaving him or her no independent assets for support. For example, the taxpayer transfers his or her residence into the FLP or LLC and continues to live there without paying rent, thereby ignoring the formality of the entity.
- The taxpayer commingles his or her personal funds with the FLP's or LLC's assets, again, ignoring the formality of the entity.
- The FLP or LLC fails to make distributions of profits to the entity's owners proportionate to their respective ownership interests. For example, the patriarch of the family takes 100% of the entity's profits after having given his children 50% of the entity's shares.

As a result, you are cautioned to do the following:

- Maintain sufficient assets outside the FLP or LLC for your own purposes.
- Observe all of the formalities when establishing an FLP or LLC, including the proper titling of assets and the proper distribution of profits to the various owners in accordance with their ownership interests.
- When you transfer a significant interest in an FLP or LLC, avoid maintaining control of the entity's profit distributions. Otherwise, you run the risk of having the IRS attack the transaction and call back 100% of the transfers into your taxable estate.

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