



The Do's and Don'ts of FLPs

Family Limited Partnerships (FLPs) have long been popular business and estate planning tools. Because assets in an FLP are excluded from a person's estate, an FLP can substantially reduce the estate's value and transfer or gift taxes.

In recent years, however, the IRS has challenged the legitimacy of FLPs under Internal Revenue Code Section 2036. FLPs are supposed to be set up so that their assets are truly separate from the transferor. Citing Section 2036, the IRS has disallowed the tax advantages of certain FLPs — or reduced the valuation discount applied — because the person who transferred assets to the FLP actually retained the use or benefit of those assets during his or her lifetime.

Note these do's and don'ts for properly structuring FLPs:

Do transfer assets intelligently. Primary residences and personal vehicles are not smart choices for transfer. If the transferor wants to use these assets during his or her lifetime, they should be kept outside the FLP. The same is true for living expenses. The transferor should retain control of enough assets to live on for a number of years.

Don't give the transferor control of distributions. Set up the FLP so that the person transferring assets does not have control of distributions. Consider setting up an LLC as general partner or giving part of the FLP interests to a charity or unrelated party.

Do include other family members' assets. If possible, include assets from more than just one family member. This reinforces the structure and business purpose of the FLP.

Don't distribute to pay expenses. To avoid the appearance of having set up the FLP purely as a tax-avoidance tool, be careful to properly time any distributions. Do not distribute funds to cover taxes, major medical bills or other major expenses, for example. Ideally, the assets in an FLP should be left to accumulate value.

Do honor record-keeping formalities. Treat the FLP as the legitimate business entity it is. Create standard bookkeeping processes, open an FLP checking account and retitle assets in the FLP's name as soon as possible. Keep detailed records as you would for any other business.

Don't create deathbed FLPs. Setting up an FLP when a widow or widower is terminally ill may imply that the entity was created primarily to dodge estate taxes. Without an appropriate period of time between asset transfer and death of the transferor, the IRS may question the legitimacy of the entity.

Remember, FLPs are still valuable estate planning tools when used correctly. Don't let recent IRS scrutiny stand in the way of setting up a legitimate FLP — just be sure to follow the rules.

Do you have questions about FLPs? If you would like to discuss FLP setup or the FLP valuation process, please let us know.

What's A Family? A Family Limited Partnership is a nontaxable entity. Its tax liability passes through to its partners, who are mainly family members. But who counts as "family"? The IRS definition includes:

- The transferor or transferor's spouse.
- The transferor's or spouse's lineal descendants and their spouses.
- Adopted children are also included, but aunts, uncles and cousins are not.