Tax Court Sharpens Tax Edge for FLPs

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For years, the family limited partnership (FLP) has been used by affluent individuals as a way to transfer business interests. Now a new Tax Court case gives this valuable estate-planning tool a distinct edge.

An FLP resembles other limited partnerships except that the shareholders are generally family members. Typically, one family member serves as the general partner and maintains control over management of the business. The limited partners (i.e., the other family members) are usually passive investors who may not provide any input into management decisions.

For starters, the FLP removes business assets from the donor's taxable estate. By using the annual gift-tax exclusion, a donor can gift up to $13,000 (for 2012) to each recipient each year without incurring any gift-tax liability. Furthermore, the income generated by the FLP is taxed proportionately to the limited partners. Generally, these younger family members will be in a lower tax bracket than the general partner, so the overall income tax liability for the family is reduced.

Finally, the limited partnership shares may be discounted in value, since there is no public market for these shares. This enables the donor to shift even more business assets to the younger generation without dire estate- or gift-tax consequences.

However, the IRS may challenge a valuation it deems to be overly aggressive. This is what happened in the new case (Wandry v. Commissioner, TC Memo 2012-88).

A married couple transferred units in an FLP to other family members in 2004. To avoid paying gift tax on the transfer, they specified that the gifts should equal the dollar amount of their gift-tax exemptions and exclusions. At the time, the lifetime gift-tax exemption was $1 million and the annual gift-tax exclusion was $11,000 per recipient. This added up to a total of $1,099,000 in gifts.

However, the gift-tax returns referenced the gifts to family members as percentage interests in the FLP, instead of using specific dollar amounts. The couple's CPA arrived at those percentage interests based on an independent appraisal. After the IRS audited the couple's 2004 gift-tax returns, it determined a deficiency based on the percentage interests listed on each spouse's gift-tax returns.

When the IRS challenges these types of valuations, it may assess additional taxes if the value increases after the gifts are made. But the Tax Court ruled that the couple legitimately intended to give gifts equal to the exemption and exclusion amounts under the clause. As a result, no additional gift tax was due.

Such a valuation may provide a guideline for other taxpayers in a similar situation. It is noteworthy that defined formula valuation clauses used for FLPs often include a “spillover” provision, with any excess value determined by the IRS going to charity. But the new Wandry case is significant because it did not include a spillover provision.

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