

Memorandum — January 25, 2006

Internal Revenue Service Scrutinizing Family Limited Partnerships for Administrative Failures

On January 6, 2006, the U.S. Court of Appeals for the Eighth Circuit affirmed the Tax Court holding in *Senda v. Commissioner* (holding that transfers of partnership interests in family limited partnerships funded with stock were indirect gifts of the stock at full value). *Senda* is one in a long line of recent cases that show the Internal Revenue Service has focused an attack on family limited partnerships ("FLP"). As part of its attack, it appears the Internal Revenue Service has heightened its scrutiny of the administration of FLPs, as recent cases have highlighted the importance of observing corporate formalities to prevent untoward tax consequences.

The Tax Court has ruled in favor of the Internal Revenue Service where it appears that the taxpayer was more concerned with the tax savings of an FLP than with the formalities of forming and administering it. At a time when the Internal Revenue Service is auditing an increasing number of gift tax returns, the following guidelines, discerned from recent cases, set forth the steps that must be taken at a minimum to withstand an attack by the Internal Revenue Service:

- At the outset, the FLP must be properly formed, all required documents filed in a timely manner and a separate FLP bank account opened.
- Legal fees and filing costs for the FLP should be paid by the FLP; if the creator pays fees and costs, the expenses should be reimbursed by FLP or carried as a liability of the FLP.
- The board and members of the FLP must follow, and satisfy the obligations outlined in, the FLP's operating agreement.
- The board and members of the FLP must hold annual or more frequent meetings, which need to be documented.
- An FLP minute book must be maintained and annual financial statements prepared.
- There must be timely documentation of transfers of interests, and required signatures should be obtained in a timely manner; the Tax Court has disregarded stock certificates prepared months after a transfer as unreliable evidence.
- The creator must not treat the FLP as a bank, and there must not be any implied agreement to administer the FLP in that manner; the creator must not contribute all of his or her assets to FLP, and no distributions should be made to fund the creator's gifts or living expenses.
- The FLP should have ongoing business operations, and conduct business transactions with non-members.
- Investments should be actively managed.

While the FLP remains a useful estate planning vehicle, any tax benefits received may be forfeited, and significant accounting and legal cost incurred, if it is not formed and administered properly. Setting up an FLP is not an end in itself; the key to maintaining tax savings and other benefits is to properly administer the entity. In that regard, the creators of FLPs must recognize the ongoing administration obligations and costs.

For Further Information

If you would like to learn more about greater detail the operational and record-keeping requirements of FLPs, please contact any member of the Estate Planning and Administration Group:

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