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Guest Article

The IRS' View On FLP Discounts: What Practitioners Should Do Now

By Jeffrey A. Baskies

Want to know what the Internal Revenue Service is telling its examiners and appeals staff regarding discounts for family limited partnerships ("FLPs")?

At an Oct. 24 Florida Bar Tax Section seminar, Mary Lou Edelstein, the national appeals family limited partnership coordinator for the IRS (and a very well-respected authority on the subject) reported on an IRS internal memo dated Oct. 19 on that subject. [See the related news story on page 1 of this issue.]

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The key elements of the memo, and thus of the current IRS position on FLP discounts, are:

1. Discount rates offered on appeal for "plain vanilla limited partnerships" should be reduced. Edelstein stated in Florida that the new tact described in the e-mail was the result of recent court cases in the valuation area. She indicated that taxpayers could expect to see "35 percent discounts" replaced by discounts in the 25 percent to 30 percent range.

2. Virtually all returns with FLP discounts will be targeted for audit. Marty Basson, another one of the panelists and the supervisory attorney for estate and gift taxes for the IRS in south Florida, indicated that estate tax return reviewers have been instructed to "select 100 percent of the family limited partnership cases." Thus, to some extent, estate tax returns showing FLP interests are being viewed as "abusive" per se on first look basis.

3. The IRS will focus more attention on the quality and content of taxpayer's appraisals. "Garden variety" appraisals performed by CPAs who are not experts are exactly the kinds of appraisals the IRS will focus on.

In light of this fresh insight into the IRS's perspective, what are planners to do?

Discount Rate

First, it doesn't appear that the discount issue is as worrisome as some have made it seem.

The IRS examiners and appeals level agents have been stemming the tide of FLP discounts for approximately a decade. It wasn't that long ago that stories of 50-percent-plus discounts were circulating for marketable securities partnerships. More recently those discounts have been generally discussed at the 35 percent level. So is a statement that the IRS will fight for 25-30 percent discounts really that significant a change?

With the threat of estate tax inclusion (*Strangi v. Commissioner of Internal Revenue*, 293 F.3d 279 [5th Cir. 2002]), chapter 14 and section 2036 arguments all still out there potentially waiting to take all discounts to zero, an internal memo suggesting settling discount cases around 25 percent doesn't seem all that bad. After all, a discount of even 25 percent on a significant FLP (let's assume a $10 million portfolio) is a pretty good tax result - saving about $1 million in that example.

Further, by coupling a 25 percent discount with other techniques (like GRATs and/or sales to grantor trusts), the discounts can lead to even greater wealth transfer savings over time.

In the end, practitioners should continue to use FLPs in proper planning circumstances and take advantage of whatever discounting they can get. What practitioners should do now is prepare clients for the discount environment they will face and set reasonable expectations. The worst thing planners can do is promise too much to clients (e.g. promise that FLPs will save them 50 percent or more of their estate taxes) only to have those promises dashed by IRS agents.

Near 100% Audit

Second, the IRS will now apparently target virtually 100 percent of all returns with FLP discounts. Again, is this a significant change in practice? Should practitioners change what they are doing in light of it?

It appears the answers are "no."

In the past, virtually any estate tax return with a sizable amount of tax was targeted for audit anyway. Moreover, as gift tax return filings have increased, the amount of gift tax returns being examined has increased. Thus for some time now, it has been fairly likely that a gift or estate tax return with substantial FLP discounting would get pulled for audit. Instead, this memo seems to memorialize that practice and legitimize it.

While it isn't good news that virtually all returns with FLP discounts will be audited, if the FLPs are properly created and managed and the discounts are properly supported by good valuation reports, it seems that the added level of examination should not hinder future planning.

Again, the lesson for practitioners appears to be one of setting expectations with clients. Practitioners should prepare clients for the anticipated extra scrutiny that their FLP returns may garner.

Appraisals

Finally, the IRS has said it isn't happy with the appraisals it has been seeing recently. This is perhaps the one area of the IRS' memo that most directly impacts how practitioners should change their ways.

Very often clients have asked their advisers to find inexpensive alternatives to highly qualified appraisals. Let's face it, the powerhouse appraisers charge large fees. And many of us have

been involved with the clients' CPA. When the clients say they want their CPA to do the appraisal, or when the CPA (who maybe referred the case in the first place) wants to do it, that can be a very difficult position. Many planners just give in and use the CPA's appraisal.

Well that seems to be a hot button for the IRS and perhaps this practice should be changed. While it will make the use of FLPs more expensive for some clients, the value of a qualified appraisal cannot be underestimated. Without one, the client's position on any return may be in jeopardy.

And what should planners be looking for in "qualified" appraisals?

According to the panel at the Oct. 24 seminar, one factor affecting the strength and validity of market guidelines is the age of the data. In particular, the panel noted that discount rates supported by the publicly registered real estate limited partnership secondary market have decreased significantly compared to prior years. So planners should quiz appraisers about the data they are using and when it was gathered.

And planners should also look for appraisers to stratify the valuation discounts by asset class.

For example, the panelists suggested appraisers should examine the U.S. Tax Court's approach in *Peracchio v. Commissioner of Internal Revenue*, T.C. Memo 2003-280 (Sept. 25, 2003). The court in *Peracchio* applied a 6 percent lack of control discount and a marketability discount that was a weighted average of the marketability discount rates associated with each asset class. Thus, FLP appraisals should now consider lack of marketability discounts for the different asset classes such as cash, bonds, stocks, real estate, and ongoing and active business practices.

In general, the panelists advised practitioners and their appraisers that the trend seems to be toward lower discounts. Recent Tax Court opinions would seem to confirm the panel's warning and indicate a trend that the judges are inclined to grant lower marketability discount rates than in prior decisions. (See *Perrachio*; *Lappo v. Commissioner of Internal Revenue*, T.C. Memo. 2003-258 (Sept. 3, 2003); *McCord v. Commissioner of Internal Revenue*, 120 T.C. 13 (May 14, 2003).)

For example, the court in *Lappo*, the panelists explained, allowed a blended total valuation discount of 35.4 percent. But underlying that blended rate was a stratification in the discounts for the asset classes. In that case, the court suggested a lack of control discount based upon 8.5 percent for the marketable securities (roughly 40 percent of the FLP assets) and 19 percent for the real estate (roughly 60 percent of the FLP assets).

And even that decision may not be a proper indicator of the current IRS thinking. The panelists pointed out that the *Lappo* case was based upon the REIT discount rates in April and July 1996. The panelists generally acknowledged that minority discounts now applicable for FLPs funded with real estate have trended lower.

So the quality of the appraiser and the quality of the appraisal are issues of greater concern to practitioners today than in the past. For those of you advising clients on FLP creation and transfer tax planning, you should take notice of this clear statement of the IRS's thinking. You should advise your clients that they cannot "take the cheaper way out," but instead must hire qualified appraisers and pay the additional fees so as to have a better chance to withstand attack on audit (which you can now assure them is almost assured).

In summary, the new IRS memo and the opinions of the seminar speakers point to a renewed interest in lowering FLP valuation discounts among the IRS examiners. They appear energized and empowered (by their superiors) to more closely examine returns with FLPs, cross-examine appraisals (particularly appraisals done by "non-professionals"), and litigate if necessary. In the wake of opinions like *Strangi*, *Lappo*, *Peracchio* and *McCord*, it seems the IRS has found effective tools to minimize the impact of some (at least the most aggressive) of the FLP discounting plans. Practitioners should take notice and advise clients accordingly.

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