Forbes.com

Partners, But Not With The Irs
Janet Novack, 04.17.00

THE IRS CAMPAIGN AGAINST FAMILY limited partnerships has suffered a striking loss in court. The case involved $1.5 million worth of stocks and Texas ranchland tucked into a family partnership by one Elsie Church, just before she died seven years ago. A federal district court judge in San Antonio ruled in January that the Church holdings could be valued at less than half that for estate tax purposes.

If Church heirs Marshall Miller and Mary Elsie Newton survive a possible appeal by the Internal Revenue Service, they won't be the only ones rejoicing. The case will be a godsend to estate lawyers who like to draft complicated documents. "The IRS is like the Texans defending the Alamo," says Laura E. Cunningham, a Cardozo School of Law professor.

It's intriguing that the Church decision took place where Santa Anna defeated the Alamo's defenders in 1836. Before you hustle to enlist in the seemingly victorious partnership army, though, recall what happened to Santa Anna when he got cocky after his victory against the Texans.

Although it has lost a few key cases, the IRS still loathes family partnerships and remains unrelenting in its scrutiny of them. With the IRS losing on the law, it will train its guns on taxpayers who make sloppy mistakes, warns S. Stacy Eastland, a Houston lawyer who has defended partnerships. "The agents are rolling up their sleeves," he says.

How is it possible to make half an estate's taxable value disappear? These partnerships shelter all manner of assets--stock, real estate, cash--with the parents usually remaining in control as general partners while giving the kids assets in the form of limited partnership units. A hypothetical outside buyer, since he couldn't control asset management or force the partnership's liquidation, would demand a discount from the underlying value of the assets in the partnership, (*see* FORBES). For the Churches, that discount amounted to more than 50%.

You can make a good case for repealing the estate tax altogether, but as long as it's on the books it's kind of nutty to let people cut it in half. So don't be surprised if the IRSgets a sympathetic ear from some judges when taxpayers give them a legal opening.

Do you still want to take a chance on this stunt? Then take these tips from the pros: **Don't tap partnership money for personal uses.** Unless you treat your partnership as if it's real, the IRS and courts won't. Consider the $1.6 million partnership set up by Charles Reichardt, of Alamo Heights, Tex., and his two children. In March U.S. Tax Court Judge John Colvin slapped it with a more than $400,000 estate tax bill.

Why? Reichardt used partnership funds to pay personal expenses. If you need cash, you must first distribute it from the partnership to all partners. **Don't set up a partnership on the cheap--**for example, by using one of those form books hawked for $2,000 or so at seminars nationwide. San Antonio lawyer Rex Cruse, who represents the Reichardts, says the family tried to cut costs by handling the accounting and property transfers themselves. The result was Dad's unfortunate handling of partnership funds. "Appearances are now very important," he says. **Don't wait until you're on your deathbed to set up a partnership.** Congress has eliminated most of the old restrictions on gifts made in anticipation of death. Tell that to the IRS. In the San Antonio case, the estate's lawyer Howard Newton, who was Elsie Church's son-in-law, says the IRS wouldn't settle because it was "obsessed" with the fact that the partnership was created just two days before her demise. (The judge found this irrelevant and coincidental: She died of a sudden heart attack.) **Don't put your home into a partnership.** It makes judges skeptical that the partnership was really set up for a legitimate business purpose, other than just saving taxes.

If you do plunk your home into a partnership, you must pay rent. (Reichardt didn't.) And the house will no longer qualify for the $500,000 per couple exemption from capital gains taxes or for special homestead tax breaks some states have. There's another vehicle, called a Qualified Personal Residence Trust, that's usually a better way to pass on your house at a discount. **Put a mix of assets into the partnership.** The courts haven't yet ruled explicitly on whether a partnership containing only publicly traded stocks has a business purpose, warns lawyer Newton. Estate lawyers report, however, that IRS auditors and appeals officers are allowing 25% to 45% discounts for all-securities partnerships, done right. **Don't mix partnerships and IRAs.** Troy, Mich. lawyer Randall Denha was aghast recently to hear that a prospective client, with a $15 million net worth, had put his individual retirement account into his family partnership. (Yep. The man had bought a forms book at a seminar.) Such a move legally terminates the IRA; income taxes on the whole amount in the IRA are immediately due. **Don't mix a partnership with an offshore trust.** To the IRS, offshore entities suggest wrongdoing. El Paso orthodontist Larry R. Price and his wife, Norma, put $3.6 million of assets in two limited partnerships and gave partnership units to a Cayman Islands trust, claiming a 56% discount. Now they're fighting an IRS bid to collect an extra $660,000 in gift taxes. **Be wary of how you mix partnerships and charity.** Some lawyers suggest clients give a few partnership units to charity to demonstrate to a judge that the family can't liquidate the partnership by itself. Former Pennzoil president Baine Kerr used this strategy in a partnership upheld by the Tax Court in December.

But a different ploy, sometimes called a charitable family limited partnership, is much dicier. In this one, the taxpayer puts hugely appreciated assets in a partnership and donates most of the units to charity. The assets are then sold, with most of the taxable gains attributed to the tax-exempt charity. But the donor retains management control.

Later, when the charity tires of the partnership's minimal payouts--remember, the donor is still in control--the charity sells its interests back to the donor's heirs at a steep discount and with the capital gains laundered. Talk about audit bait.

Finally, you might want to wait and see if Congress raises the estate-tax exemption, now $1.35 million per couple, and scheduled to rise to $2 million in 2006. Some lawyers figure it may go as high as $5 million per couple. If you're middle-aged, you have time. Why go through the expense (maybe $10,000 to $20,000 in lawyers' fees) and bother now of creating a family partnership? Not to mention the risk of an IRS frontal assault.