BEWARE! Impact of New Tax Rules on Your Family Limited Partnership

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Family limited partnerships ("FLPs") are a common estate planning technique. They permit centralized asset management, provide liability protection, and create a mechanism by which one generation can transfer wealth to the next without giving up control. Like all partnerships, FLPs do not pay federal income tax. Instead, an FLP's income is "passed through" to its partners, who pay tax at their own rates. Under current law, if an IRS exam (audit) determines that an FLP underreported its income, such that the partners underpaid their taxes, the IRS collects the additional tax due from the partners. Parts of this fundamental "pass through" feature are about to change.

Under new partnership audit rules that will soon take effect, if the IRS determines that tax on an FLP's income was underreported, it collects the tax from the FLP itself, not the partners. In this scenario, the FLP generally pays tax at the highest individual or corporate rate.

Rather than paying the tax itself, an FLP can elect to "push out" the tax liability to the people who were partners during the year under audit, restoring the pass-through treatment to which FLPs are accustomed. The "push out" election is made by the "Partnership Representative," who is a partner or other person designated in accordance with the partnership agreement. This election has to be made on a timely-filed Form 1065 (partnership return), and if the Partnership Representative fails to make it, the opportunity is lost.

Certain partnerships can elect out of the new regime entirely, but the typical FLP will not qualify to do so. To elect out, a partnership must have 100 or fewer partners, all of whom are individuals, corporations, or estates of deceased partners. Under the proposed regulations, a partnership that has even one partner that is a disregarded entity (e.g., a single-member LLC), a partnership (including a multi-member LLC), or a trust cannot elect out. Most FLPs have at least one "non-qualifying" partner (typically, an LLC is the general partner of an FLP), making the FLP ineligible to elect out. As a result, the typical FLP will be subject to the new audit (and tax) regime.

RECOMMENDATIONS

In light of the new rules, the FLP should consider.

- **Requiring a "Push-Out" Election to Protect the Younger Generation(s).** Unless the FLP makes a push-out election, if a parent gifts all or a portion of his or her FLP interest to a child or grandchild, the parent is off the hook for any underpayment of tax that arose during a year he or she owned the gifted FLP interest, and the younger family member will bear the economic cost when the partnership pays the tax. To protect the financial interests of the younger family members, the partnership agreement can require a push-out election following an audit to protect the value of a child's or grandchild's partnership interest. An added benefit of such a provision is that, when the tax is "pushed out" to the historic owners, the value of the parent's (taxable) estate will be reduced.
- **The New Rules May Pit Family Members Against One Another.** Envision the following scenario: An FLP is owned by siblings, the children of the original partners. Brother has tax losses outside the FLP that are available to offset his share of the tax that is "pushed out," so he favors a push-out election. Sister does not have tax losses and would have to go out-of-pocket to pay her share of the tax. She does not want the Partnership Representative to make a push-out election, so that the FLP will pay the tax. Unless the partnership agreement provides for "(super-) majority rule" or another method for the partners to decide whether a push-out election will be made, the decision is in the hands of the Partnership Representative.
- **Identity of the Partnership Representative is Critical.** Unlike the "Tax Matters Partner" that exists under current law, the Partnership Representative has the sole authority to bind an FLP and its partners to any decision made by the representative at every stage of the audit proceeding, as well as the power to pick winners and losers among the partners (e.g., choosing whether to make a push-out election). While under current law, the Tax Matters Partner's role is ministerial, or involves issues on which all partners' interests usually are aligned, the Partnership Representative's role affects the partners' relative economics. Partners should choose the Partnership Representative with care and should consider including a mechanism to direct the Partnership Representative in their partnership agreements. If an FLP has not designated a Partnership Representative, the IRS has the authority to designate one for the partnership.

When the new rules take effect in 2018, it will no longer be "business as usual" for FLPs. The new rules have the potential to shift tax liability and even create discord among partners. Strasburger & Price's Tax and Estate Planning attorneys would be pleased to discuss the effect of the new rules on your FLP and to help you implement strategies to avoid problems in the future.