Family limited partnerships can provide significant tax and non-tax benefits for families with real estate investments. Yet, as with any business decision, tax and non-tax benefits must be compared first with tax and non-tax costs.

COLUMN BY JERROLD J. STERN

Family limited partnerships (FLP) offers financial benefits

A typical family limited partnership (FLP) consists of parent and children partners. The children acquire their partnership ownership interests as gifts from the parents. Because partnerships pay no tax to the federal government, each partner reports their share of partnership net profit or loss on their own tax return. In all limited partnerships, at least one partner (a general partner) is required to have unlimited liability—meaning they have unlimited personal liability with respect to potential lawsuits.

A limited liability company (LLC) used as a FLP should provide all the benefits and features of partnership taxation plus provide limited liability for all owners. The IRS, however, has not yet ruled on LLCs used as FLPs. Tax costs and benefits. FLPs can provide tax savings from the income tax and the estate tax. To achieve these savings, parents first gift an FLP interest to a child. The gift, however, may be taxable. Assuming two parents, gift taxes are avoided if the gift’s discounted fair market value is less than the sum of $20,000 ($10,000 annual gift tax exclusion per donee per parent) and the $1,300,000 (in 1999) lifetime combined gift/estate tax exclusion of the parents.

The discounted fair market value aspect is a major attraction of FLPs. For example, assume parents own income-producing real estate valued at $6 million. They form an FLP with their only child and gift the child a one-third partnership interest. What is the gift tax value of the child’s interest? Because the interest is a minority (non-controlling) interest and does not have ready marketability, its value is substantially less than the value of the underlying real estate. The IRS allows the value for tax purposes to reflect a 20 to 50 percent discount. Using a 40 percent discount, this transaction completely avoids gift tax: $2 million (1/3 of $6 million), less $800,000 (40 percent discount), less $20,000 combined annual gift tax exclusion, less $1,180,000 (of the $1,300,000 lifetime combined gift/estate tax exclusion).

Once the gift is made, tax advantages are that the parents’ taxable estate is reduced by the $2 million real estate value transferred to the child plus all of the future appreciation on the one-third share of the real estate. Further, the interest remaining to the parents may be subject to larger discounts as each parent’s community share is only one-third. Moreover, income tax on net income produced by the property is reduced if the child is more than 13 years old and his marginal income tax rate is less than the parents’ marginal income tax rate. For example, assume the property generates taxable income of $300,000 per year. One-third, or $100,000, is taxed at the child’s tax rate (an average rate perhaps as low as 25 percent) rather than the parents’ tax rate (possibly 40 percent or higher), potentially saving $15,000 or more per year.

Non-tax benefits. Children can be formally brought into the family business without the parents giving up control (because they still retain more than 50 percent ownership). Family assets are protected from third parties and the spouses of family members. Consolidating family assets may prevent them from being sold by disgruntled family members. This is accomplished by including buy-sell type provisions in the partnership agreement. FLPs also simplify future gift giving. For example, the parents’ partnership interests can be gifted to children over a period of years rather than all in one year.

A general advantage of FLPs is that they can take advantage of flexible treatment offered by partnership tax rules. For instance, under the partnership
agreement, deductions (or income) can be specially allocated to high (or low) tax bracket partners, as long as the allocation has economic substance, for maximum tax advantage.

**Additional costs and caveats.** Experienced legal and tax advisors must be used because the IRS carefully reviews FLPs, especially the valuation rationale for discounted gift values of partnership interests. One key requirement for defending an FLP transaction is that there must be a business (non-tax) purpose for establishing the FLP. The IRS has recently attacked FLPs established shortly before the death of one of the parents because it viewed the FLP to be nothing more than a vehicle to reduce the parent’s estate tax. In the words of one tax commentator, “Family limited partnerships today are not for the faint of heart.”

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