

## Family Limited Partnerships

Family partnerships have long been used as a tax reduction device by astute tax planners. In the pre-Reagan era of high marginal income tax rates, family partnerships were often used to shift income from family members in a high tax bracket (i.e., the parents) to those in a lower bracket (the children). In a typical case, a parent who owned an income-generating business or piece of real estate would transfer it to a partnership and then make gifts of limited partnership interests to his or her children. A portion of the income from the business or real estate could then be directed to the children, who would usually be subject to a much lower tax rate than their parent.

The use of family partnerships tapered off after the 1986 Tax Reform Act for two reasons. First, the lowering of the top income tax rates reduced the incentive to shift income to family members in lower brackets. The second reason was the enactment of the “kiddie tax,” which subjected passive income received by children to the same tax rate that was paid by their parents. As a result, there was no longer a strong income tax incentive to creating a family partnership.

In the early 1990s, however, family limited partnerships were revived as an estate tax planning tool. The critical stimulus was the IRS’s publication of its Revenue Ruling 93-12, in which it formally abandoned its discredited “family attribution” theory. Before this ruling, the IRS had taken the position that the interests of all family members must be considered when valuing a gift of an interest in a family-controlled entity. For example, if Father, who owned 100% of the common stock in a family business, made a gift of 10% of the stock to each of his three children, the IRS took the position that none of the gifts qualified for a minority interest discount since the children’s holdings were attributed to him and vice versa; hence, the family still owned 100% of the corporation.

After consistently losing on this issue in court, the IRS published Rev. Rul. 93-12 to announce its acquiescence on family attribution. As a result, in the example above, Father was now allowed to take a minority interest discount on the value of each of the gifts to his children, thereby reducing the gift tax liability on the transfers.

Alert tax practitioners soon realized that the family limited partnership was an ideal vehicle for taking advantage of the discounts to reduce transfer taxes (a term covering gift, estate and generation-skipping transfer taxes) rather than income taxes. Family

## Family Limited Partnerships (cont.)

partnerships were now funded with assets other than business interests and real estate, since income from the contributed property was no longer a factor in the decision to create a partnership. The new type of family limited partnership could be funded with a variety of assets, including investment assets and assets that produced little or no income. It bears noting that the Service and the Tax Court issued rulings promptly holding that discounts will be disallowed if the only asset is the parent's brokerage account, since there is no legitimate business purpose for the entity).

Under current practice, a parent (or grandparent) creates a family limited partnership, naming himself (or a separate corporate entity) as the general partner. The parent will generally contribute most of the assets to the partnership. Typically, he will receive a 1% general partnership interest (to ensure continued control) and the remaining 99% as limited partnership interests. Ideally, the children (or grandchildren) will make modest contributions to the partnership in return for relatively small limited partnership interests. The parent will then begin to make gifts of his limited partnership interests to the children. These gifts will be subject to significant discounts, perhaps as much as 45%, depending upon the size of the transfer and the restrictive features drafted into the partnership agreement.

As a demonstration of the tax savings that are possible in a family limited partnership strategy, assume that Father contributes \$980,000 in stocks and bonds to a family limited partnership in return for a 1% general partnership interest and a 97% limited partnership interest. At the same time, his two children each contribute \$10,000 in cash to the partnership in exchange for a 1% limited partnership interest.

Several months later, Father decides to make a gift of a 10% limited partnership interest to each of the children. Each 10% interest represents \$100,000 in partnership assets, but Father claims that the 10% partnership interest, because of restrictions imposed by the partnership agreement, must be "discounted" to only \$50,000. In addition, each gift qualifies for the annual exclusion from gift tax, which is \$13,000 per donee in 2011. Thus, each such taxable gift would be reduced by the exclusion, or \$37,000. By using the partnership to make gifts of the underlying assets, Father is able to transfer \$100,000 of his resources to each child, while treating it as a gift of

## Family Limited Partnerships (cont.)

\$37,000 (if made in 2011) for tax purposes. Over time, Father can transfer his entire 97% limited partnership interest to the children at a significantly reduced gift tax cost, while still maintaining control over the partnership operations as the general partner. If the partnership is administered properly, only that 1% interest will be taxed in his estate at death.

The IRS continues to audit taxpayers and to pursue cases through to the appellate courts on specific issues in order to create legal precedents challenging the use of family limited partnerships for estate tax discounting. For now, it appears the IRS must allow reasonable discounts for gifts of limited partnership interests, although the increase in the estate tax exemption amount to \$5 million per taxpayer as of January 2011 may tend to reduce the urgency for making discounted gifts or even the creation of new partnerships solely for the potential estate tax savings. Still, family limited partnerships remain a popular estate and gift tax planning vehicle, especially since they perform many viable, non-tax functions in the family business setting.

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