NEW DATA ON FAMILY LIMITED PARTNERSHIPS REPORTED ON ESTATE TAX RETURNS

Brian Raub and *Melissa Belvedere,* Statistics of Income, IRS*

Family limited partnerships (FLPs) have become an increasingly popular tax planning instrument in recent years. While the concept of family limited partnerships is well established within the tax planning community, FLPs do not have any specific legal or tax definition, nor are they subject to any special reporting requirements. Thus, despite their increased popularity, little data have been available to shed light on the characteristics of FLPs or the role they play in estate planning.

Previously, the Statistics of Income Division of the IRS (SOI) has published limited data, including asset composition and valuation discount data, on FLPs extracted from Forms 706, *United States Estate (and Generation-Skipping Transfer) Tax Return* (Raub, 2008). This paper presents data from a new dataset created by linking estate tax return data to earnings data reported on Schedule K-1 filings for these partnerships. These new data help shed light on the role that FLPs play in estate planning by providing information about the characteristics of decedents whose estates include FLPs, the characteristics of the FLPs themselves (including their asset composition), and the role that FLPs play in the financial affairs of wealthy individuals.

BACKGROUND ON FLPs

The tax planning community uses the term "family limited partnership" to refer to a limited partnership in which the majority of the partners are related. This type of partnership is often used to hold and manage family businesses or investment assets. In the simplest arrangement, an individual or couple creates and funds an FLP with a variety of assets. The creators typically name themselves as general partners, retaining full control of the FLP regardless of the number of partnership shares they own. The creators then distribute the limited partnership shares, which convey no decision-making authority or control over the FLP, to other family members, usually children. The creators often gift these shares over a period of time.

As a result of their split-ownership structure, FLPs provide a myriad of estate planning benefits. For example, they can provide asset protection from creditors and allow more management flexibility than would be possible with a trust. FLPs also allow the ownership of assets to be distributed throughout a family while still allowing the general partner(s) to retain full control. Characteristics inherent to FLPs—the fact that limited partnership shares convey no control over the FLP, the family-only nature of the partners, and the often personal nature of the underlying assets—significantly reduce the marketability of limited partnership shares. These characteristics may make FLPs eligible for valuation discounts. When applied, valuation discounts reduce the value of the FLP's underlying assets for gift tax purposes when its shares are given to family members during the FLP creator's life and for estate tax purposes following the creator's death.

BACKGROUND ON SOI'S ESTATE TAX STUDY

The federal estate tax, enacted by the Revenue Act of 1916 and described in Internal Revenue Code (IRC) Subtitle B, Chapter 11, is a tax on the transfer of property at death (Luckey, 2003). For deaths that occurred in 2004, the filing threshold for property transfers at death was $1.5 million in total gross estate. Analysts in SOI conduct the Estate Tax Study annually, extracting demographic, financial, and bequest data from Forms 706, *United States Estate (and Generation-Skipping Transfer) Tax Return.* The study is designed to allow production of both annual filing year data on estate taxation as well as triennial year-of-death estimates. The latter estimates are advantageous in that the included estates would have been subject to the same tax law and similar economic conditions. A single year of death is sampled for three calendar years to ensure near-complete coverage of the population of decedents for a given year,

*The views expressed in this paper represent the opinions and conclusions of the authors alone. They do not represent the opinions of the Internal Revenue Service or the Treasury Department.

since about 99.0 percent of all returns are filed by the end of the second calendar year following the decedent's year of death. Of the 37,956 total returns sampled during 2004-2007, there were 11,817 returns sampled for 2004 decedents out of a total population of 42,239 returns.

Estate tax returns were sampled while returns were being processed for administrative purposes but before any audit examination. Returns were selected using a stratified random probability sampling method, with the sample rates based on the desired sample size and an estimate of the population. There were three stratification variables: year of death, age at death, and size of total gross estate plus adjusted taxable gifts.

SOI determined the presence of FLPs on estate tax returns by evaluating two characteristics—the partnership's name and its ownership structure. In most cases, FLPs were named using the decedent's name followed by "family limited partnership" or similar terminology. SOI evaluated the ownership structure by examining the attachments to estate tax returns for characteristics unique to FLPs, such as the decedent reported as a general partner, close family members reported as general partners, and ownership shares that had been discounted to reflect minority ownership and lack of control and marketability. Due to the lack of an explicit legal definition, it is possible that SOI failed to detect some FLPs associated with decedents in the sample because the partnerships exhibited neither evaluation characteristic.

THE DATA

We developed the current dataset by isolating decedents from the 2004 year-of-death study whose estates contained an FLP. We then linked the estate tax data from those decedents to a separate dataset containing Schedule K-1 data, which provided information on the number and type of other entities receiving income from, or paying income to, the FLPs. Partnerships prepare and file Schedules K-1 with Forms 1065, *U.S. Return of Partnership Income,* to report each partner's share of the partnership's annual income, deductions, and credits. Partners could be individuals, trusts, partnerships, or other corporations.

We identified an estimated 1,513 decedents associated with one or more FLPs in the 2004 year-of-death sample, or 4.0 percent of all 2004 decedents. Of that total, we were able to associate 1,133 decedents with a single FLP using the K-1 data. In addition, we identified 223 decedents who were associated with more than one FLP; these decedents had a combined total of 501 FLPs. Finally, we found 157 "match failures," or decedents for whom it was impossible to establish a definite association with an FLP, in the K-1 data. This could have resulted from improper identification of FLPs in the SOI data editing process or may reflect cases where no K-1 returns were filed because there was no income to report.

In the following analysis, we generally separated estate tax decedents into three groups – those whose estates did not contain FLP assets, those whose estates contained one FLP, and those whose estates contained multiple FLPs. While the interaction between an estate and a single FLP was relatively straightforward, the interactions of an estate which contained multiple FLPs were too complex to observe fully in the collected data. Thus, we were often able to conduct more detailed analyses for cases where a decedent had a single FLP than for cases where the decedent had multiple FLPs. The data revealed that there were significant differences between decedents whose estates included one FLP and decedents whose estates included multiple FLPs.

Decedent and Estate Characteristics

Figure A displays the demographic profile of decedents with one FLP, multiple FLPs, or none at all (non-FLP decedents). One noteworthy difference shown in the figure is that decedents with FLPs had, on average, significantly larger estates than decedents without an FLP. Decedents with multiple FLPs had the largest average total gross estate, $9.6 million, an amount 39.1 percent greater than the average total gross estate for decedents with one FLP and more than twice the average for non-FLP decedents. A second noteworthy difference relates to the marital status of the decedents in each of the categories. While the percentage of single-FLP decedents who were married was similar to the corresponding percentage for non-FLP decedents, a much higher percentage of multiple-FLP decedents were married (66.0 percent).

As shown in figure B, there were also significant differences in the asset portfolios of decedents with and without FLPs, notably in the percentage held in investment real estate and business assets (note that the asset breakdown for single- and multiple-FLP decedents includes the assets held

Figure A: **Profile of 2004 Estate Tax Decedents**

Characteristic	Type of decedent		
	Non-FLP	Single-FLP	Multiple-FLP
Average total gross estate	$4.3 million	$6.9 million	$9.6 million
Sex (percent of total)			
Male	56.4	53.3	60.7
Female	43.6	46.7	39.3
Marital status (percent of total)			
Married	46.2	44.7	66.0
Widowed	40.1	47.8	29.0
Single	13.7	7.5	5.0
Average age	79.3	80.3	77.8

Figure B: **Mean Percentage of Total Assets Calculated for Asset Components, by Type of Decedent**

Asset type	Type of decedent		
	Non-FLP	Single-FLP	Multiple-FLP
Publicly-traded stock	24.2	21.8	19.5
Investment real estate	16.0	23.0	23.6
Bonds	13.6	11.0	9.2
Personal residence	12.5	9.2	5.2
Cash	11.7	8.7	9.8
Retirement assets	9.8	8.3	4.9
Insurance	3.2	2.0	1.3
Closely-held stock	3.0	4.5	5.6
Business assets	2.7	5.3	14.6
Mortgages and notes	1.7	4.2	3.2
Other assets	1.7	2.1	3.0

within the FLPs themselves). On average, non-FLP decedents held the largest shares of their portfolios in publicly traded stock (24.2 percent) and investment real estate (16.0 percent), but only a small percentage of their estates were held in closely-held stock or business assets. Closely-held stock is defined as stock of a closely-held—often family-owned—corporation; business assets are defined as an unincorporated business, such as a sole proprietorship or partnership. By comparison, for decedents with FLPs, publicly traded stock represented a somewhat smaller share of the estate, while investment real estate and business assets made up significantly larger shares. Business assets accounted for 5.3 percent of the portfolio of single-FLP decedents, nearly twice as great a percentage as held by non-FLP decedents. For multiple-FLP decedents this percentage was even greater, 14.6 percent. These data suggest that the use of FLPs in financial and estate planning was significantly connected with the ownership of investment real estate and small businesses, particularly for cases where an individual had multiple FLPs.

Asset Composition of Single FLPs

Having looked at the characteristics of decedents with FLP assets in their estates, we then analyzed the characteristics of the FLPs themselves. In this section we limited our analysis to cases where an estate contained a single FLP because, as described above, the relationship between the estate tax return data and the FLP in these cases is straightforward. As shown in figure C, the average tax value (net of any valuation discounts) of single FLPs was $1.83 million, or 26.5 percent of the value of the associated estates. Investment real estate and business assets combined to make up the majority of the value of FLPs, an observation consistent with the analysis of figure B. Compared to the overall asset portfolio of single-FLP decedents, the FLPs contained greater shares of investment real estate and business assets and lesser shares of each of the other asset types. For example, while single-FLP decedents held, on average, 23.0 percent of their overall estates in investment real estate, this asset class accounted for an average of 41.8 percent of the value of these decedents' FLPs. The concentration of business assets in the FLP was even greater: while this asset class made up a mean of 5.3 percent of the overall value of the estate, it accounted for 17.4 percent of the value of the FLP on average.

Income Payments Between FLPs and Other Entities

In addition to asset composition, another piece of information that may shed light on the role that FLPs played in the financial lives of decedents is the extent to which they paid income to, or received income from, other entities. Overall, the FLPs observed through the K-1 data paid income to, or received income from, an average of six other entities. The average, however, conceals differences between cases where a decedent had only one FLP and those where the decedent had multiple

Figure C: **Mean FLP Value and Mean Percentage of Total FLP Assets Calculated for FLP Asset Components, Single FLPs**

Single-FLPs	
Mean FLP value	1,825,739
Asset breakout	
Publicly-traded stock	19.3
Investment real estate	41.8
Bonds	8.9
Personal residence	0.1
Cash	5.9
Retirement assets	< 0.1
Insurance	< 0.1
Closely-held stock	4.2
Business assets	17.4
Mortgages and notes	1.9
Other assets	0.6

FLPs, as shown in figure D. There was virtually no difference in the percentage of either single or multiple FLPs that made payments to individuals (98.5 percent) or to trusts (71.7 percent). However, there were significant differences in the pattern of income payments to and from partnerships for cases where a decedent had multiple FLPs compared to cases where there was only one FLP. Of particular note is the fact that nearly 10.0 percent of multiple FLPs paid income to another partnership, compared to only 2.0 percent of single FLPs. Although not shown, research revealed that some of the income payments between the multiple FLPs and other partnerships represent direct payments between the multiple FLPs themselves. These results suggest that these FLPs were interrelated in a relatively complex way with the business affairs and financial assets of their associated decedents and that the complexity of this relationship was greater for multiple-FLP decedents than for single-FLP decedents.

Lifecycle of FLP Filings Relative to Decedents' Deaths

Examination of the timing of FLP K-1 filings, particularly the timing of initial and final filings relative to the death of the partnership's creator, may provide key insights into the decedent's intent in establishing the FLP. For "short-lived" FLPs that began filing shortly before the death of the estate tax decedent and stopped filing shortly after death, the use of valuation discounts may have been a more important factor in the partnership's creation than the long-term management and protection of family assets. However, less than 5.0 percent of single FLPs were "short-lived." As shown in figure E, the majority of all single FLPs, an estimated 64.9 percent, were filing Schedules K-1 4 years prior to the year of the associated estate tax decedent's death, with a greater percentage, 79.1 percent, still filing Schedules K-1 3 years after death.

An FLP composed solely of highly marketable, liquid assets, such as publicly traded stock, bonds, and cash, may be another indicator that the creation of the partnership was not primarily motivated by the long-term management and control of family assets. As shown in figure E, these "financial FLPs" did exhibit a somewhat different filing pattern than FLPs as a whole. Compared to all FLPs, fewer financial FLPs were filing K-1 returns for all years surrounding the decedent's year of death. The difference is most noteworthy in the third year after the decedent's year of death; while almost 80.0 percent of all FLPs overall were still filing K-1 returns three years after the decedent's death, only 61.0 percent of financial FLPs were filing at that point.

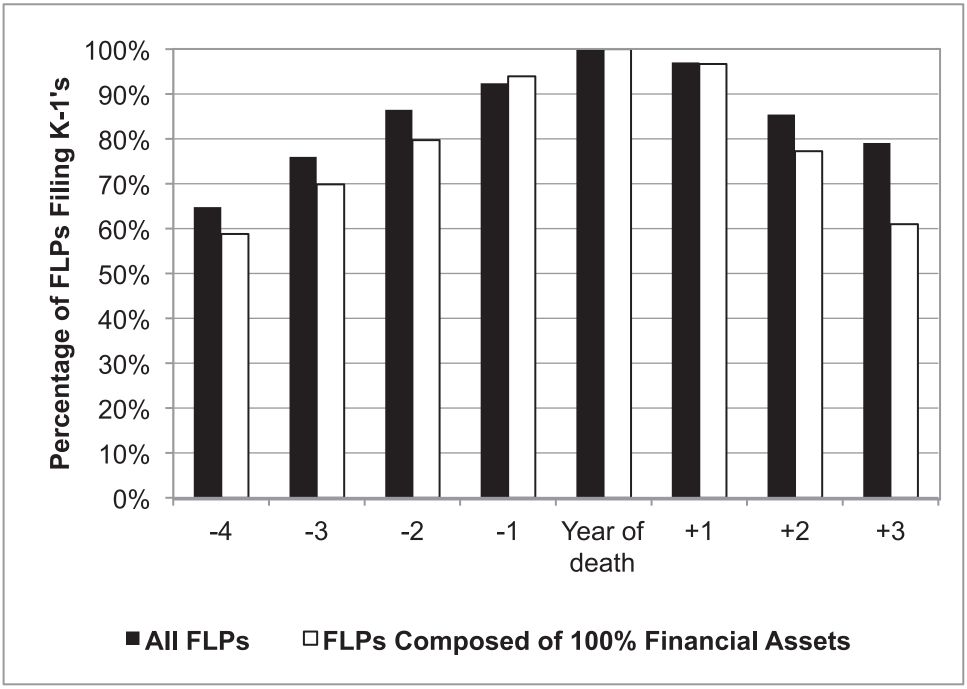
CHARACTERISTICS OF DECEDENTS WITH SINGLE FLPS UTILIZING VALUATION DISCOUNTS

Valuation discounts on assets held in limited partnerships and other types of businesses are frequently claimed on estate tax returns. Valuation discounts on shares of limited partnerships are usually based on the fact that these shares convey no control over the underlying assets and are thus relatively illiquid. As a result, assets held in limited partnerships may be worth less than

Figure D: **Income Payments to and from FLPs**

Tax entity and payment type	Type of FLP	
	Single	Multiple
Individuals and Trusts		
FLP to individuals	98.5	97.8
FLP to trust	71.7	72.8
Partnerships		
FLP to partnership	2.2	9.6
Partnership to FLP	16.4	22.0

Figure E: **Percentage of Partnership Returns for Single FLPs Filing K-1's Relative to Year of Estate Tax Decedent's Death, All FLPS and Those Composed of 100% Financial Assets**



their fair market value would be in the absence of the partnership. Assets discounted for estate tax purposes on Form 706 lower the total gross estate, which in turn may lower an estate's tax obligation.

In the following sections, we focus on how the use of valuation discounts on FLPs reported on estate tax returns differs based on the demographic profile of the decedent and the asset composition of the FLPs. SOI calculates valuation discounts as the dollar value of the discount divided by the pre-discount dollar value of the FLP. In our analysis, we defined small discounts as those less than 22.0 percent of the total value of the FLP, medium discounts were those between 22.0 percent and 40.0 percent of the value of the FLP, and large discounts were those in excess of 40.0 percent of the FLP's value. Of the estimated 1,133 single FLPs in the dataset, 751 (66.3 percent) included a valuation discount on assets in the partnership.

As shown in figure F, there was a significant difference in the gender distribution of decedents whose estates included a valuation discount on FLP assets. The estates of male decedents more frequently claimed no discount or a small discount, whereas the estates of women claimed medium- to large-sized discounts much more often. Furthermore, fewer estates of married decedents claimed a valuation discount of any size, compared to the estates of widowed decedents. This difference is likely because married decedents would have had less incentive to use valuation discounts as a means of reducing the estate value for tax purposes. The estates of married decedents nearly always use the unlimited marital deduction, which eliminates estate tax liability on assets bequeathed to the surviving spouse. Furthermore, married decedents have an incentive to pass assets to a surviving spouse at face value using the marital deduction. Doing so allows the surviving spouse to use the

Figure F: **Demographic Profile of Single-FLP Decedents, by Size of Valuation Discount on FLP Assets**

Characteristic	Size of discount			
	None	Small	Medium	Large
Average age	76.9	81.4	82.4	81.7
Sex (percent of total):				
Male	60.6	78.3	41.5	36.5
Female	39.4	21.7	58.5	63.5
Marital status (percent of total):				
Married	58.4	41.6	31.2	46.7
Widowed	32.4	46.4	63.1	49.2

Figure G: **Mean Percentage of Total FLP Assets Calculated for FLP Asset Components, by Size of Valuation Discount on FLP Assets**

Asset type	Size of discount			
	None	Small	Medium	Large
Publicly-traded stock	13.7	18.9	27.7	14.7
Investment real estate	34.0	42.0	44.4	52.0
Bonds	5.0	13.7	11.9	6.0
Personal residence	< 0.1	< 0.1	0.3	0.1
Cash	9.1	4.0	4.1	4.7
Retirement assets	< 0.1	< 0.1	< 0.1	0.1
Insurance	< 0.1	0.2	< 0.1	< 0.1
Closely-held stock	4.9	7.1	0.8	6.3
Business assets	31.8	9.1	8.9	13.2
Mortgages and notes	1.0	4.1	1.3	2.7
Other assets	0.4	0.9	0.7	0.2

date of death value of the assets as the basis value when calculating capital gains.

Asset Composition of Single FLPs with Valuation Discounts

As shown in figure G, there are several noteworthy differences between the asset compositions of single FLPs for which discounts of various sizes were claimed. FLPs for which no discounts were claimed were composed of greater shares of business assets than their discounted counterparts, regardless of the size of the discount relative the FLP's value. While the asset compositions of FLPs for which small or mid-sized valuation discounts were claimed were relatively similar, FLPs for which the largest discounts were claimed were composed of higher percentages of investment real estate and business assets and smaller percentages of publicly-traded stock and bonds than their smaller-discount counterparts. This may reflect the fact that investment real estate and small business assets are not just illiquid, but also relatively challenging to value because their valuation process tends to be subjective and imprecise. Therefore, larger discounts taken on FLPs composed mainly of these asset types may reflect the greater difficulty of finding investors for such illiquid assets with a large share of family ownership.

SUMMARY

A unique dataset that links data on family limited partnerships collected from estate tax returns to Schedules K-1 filed by these partnerships shows that FLPs often play a relatively complex role in the financial affairs and estate planning of wealthy decedents. This seems to be particularly true for those decedents who owned a significant share of their portfolios in small businesses and investment real estate. Of the estimated 1,356 decedents with FLPs, 83.6 percent had one FLP, while 16.4 percent had two or more FLPs. Decedents with FLPs had, on average, significantly larger estates than decedents whose estates did not include an FLP and multiple-FLP decedents had larger estates, on average, than single-FLP decedents. The estates of decedents with FLPs were composed of greater shares of business assets and real estate than the estates of decedents without an FLP. Decedents with multiple FLPs were disproportionately married men with businesses.

Single and multiple FLPs both showed a similar pattern of income payments to individuals and trusts, although multiple FLPs tended to make income payments to other partnerships at a higher rate than single FLPs. A significant percentage of both types of FLPs reported income payments from one or more other partnerships, but multiple FLPs reported income from other partnerships at a higher rate. These facts suggest that FLPs are often intertwined with the business affairs of wealthy decedents, particularly in the case of multiple-FLP decedents.

The majority of single FLPs were filing Schedules K-1 at least four years prior to and three years after the death of the linked estate tax decedent, although this was true less often for FLPs composed solely of marketable, relatively liquid financial assets such as cash, bonds, and publicly-traded stock. As previously noted, only a very few FLPs were "short-lived," meaning that they began filing Schedules K-1 less than three years before the estate tax decedent's death and ceased filing less than three years after the estate tax decedent's death.

Although valuation discounts are often cited as a primary reason for the creation of an FLP, valuation discounts were claimed on only about two-thirds of single FLPs. Discounts were claimed on the FLPs of married decedents much less often than on the FLPs of widowed decedents. FLPs on which the highest discount rates were claimed held greater shares of real estate and business assets and smaller shares of publicly traded stock and bonds, than FLPs on which lower discount rates were claimed. This behavior seems to reflect the practicalities, advantages, and disadvantages of both valuation discounts and the liquidity of the assets in the FLPs, as well as the marital status of the decedents themselves.

A key question in analyzing the life cycle of FLPs and their roles in estate planning is how to interpret the timing of when the partnership starts and stops filing Schedules K-1 relative to the year of the associated decedent's death. Although it is not possible to determine the intent of the FLPs' creators, it seems clear from these data that relatively few FLPs are short-lived, simple financial instruments, and that the relatively complex roles these partnerships play in the financial lives of wealthy individuals bear further study. Opportunities for further research in this area include: identifying the dates that estates made final settlement with the IRS; comparing this information to the dates that corresponding FLPs stop filing Schedules K-1; and connecting these data to gift tax return data.

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