Transfer land, reduce taxes with family limited partnership

Farm & Family

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AS farmers and agricultural landowners begin to discuss estate planning, two questions that inevitably arise are how to transfer farmland to the next generation while living, and how to reduce the amount of estate taxes due upon death.

A family limited partnership is an estate planning tool that can help clients accomplish these goals.

In a typical FLP, husband and wife transfer their farmland to the FLP in exchange for both general and limited partnership shares. The general partners have complete control over the assets, whereas the limited partners are only allowed to share in the distributions. The number of general partnership shares is dependent on the number of total children and the number of farming heirs.

For example, if a husband and wife have four children, two of whom farm, initially, the husband and wife will each have a 1% general partnership interest and a 49% limited partnership interest. Upon a death, a ½% general partnership interest will go to each farming heir. The limited partnership shares will be distributed so that the end result will be that each child owns 25% of the total shares.

Thus, after both husband and wife have passed, each farming heir will own a 1% general partnership interest and 24% limited partnership interest, and each non-farming heir will own a 25% limited partnership interest. As general partners, the two farming heirs will have complete control over the operation of the farm, but all four children will share the profits equally.

Gifting benefits

The largest benefit of FLPs is they allow you to gift real estate during your lifetime at a discount. Within the operating agreement are restrictions on transferring shares, as well as terms that provide only the general partners with control over the operation.

Discounts are given for both lack of marketability and lack of control. Under federal gift tax laws, individuals are allowed to gift $14,000 to any other individual each year. Thus, the husband and wife could give $28,000 to each of their four children each year.

By gifting limited partnership interests, as opposed to the real estate itself, husband and wife are actually able to gift more than $28,000 in land due to the discounts for lack of marketability and lack of control of the limited partnership shares. Because they remain general partners, they maintain control over the FLP. The typical discount is anywhere from 25% to 40%.

Using discounts, parents can gift approximately $35,000 to $40,000 of land to each child each year, which in the husband and wife's case would reduce their gross taxable estate by up to $160,000 each year.

Provisions in the operating agreement allow husband and wife to put restrictions on the land for the next generation. Common provisions in the operating agreement include a first right to rent the land to a descendant, occasionally at a discounted rate; a restriction on the sale of land and partnership interests; and a first right of refusal to the descendants' heirs that allows them to purchase the shares at specified terms.

FLP pays taxes on land, insurance

Each year the tenant, i.e., the sole proprietorship or operating entity, pays rent to the FLP. The FLP pays the real estate taxes and insurance on the land. The FLP then decides whether or not to distribute the net rent out to the partners.

However, the partners are taxed on their share of the income regardless of whether a distribution is made. If the general partners want to keep the rental income in the partnership, they typically distribute at least enough to each partner to cover their respective tax burdens. Income is reported on a schedule K-1, and the FLP files a Form 1065.

The FLP should be used in conjunction with a revocable living trust. The revocable living trust allows you to plan for incapacity by designating who will vote your shares if you are incapacitated. A trust also allows you to specify how both the general and limited partnership shares are distributed at death to allow for continued success.

FLPs can help clients significantly reduce a potential estate tax burden. However, a plan needs to be implemented. Visit with an estate planning attorney experienced in the area of family limited partnerships to discuss your specific situation.

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