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Help! I'm Stuck in My FLP!

Options Available to Those Who May Have Outgrown Their Family Limited Partnership

By: Geoff N. Germane, J.D.

Right after tax season, many accountants share stories of the frustration and angst expressed by their clients who are disenchanted with their family limited partnerships ("FLPs"). What seemed like a great idea when it was established may have become onerous to administer, and the family begins to question the benefits.

As good planning is driven by a client's objectives, a review of the reasons the FLP was originally formed is helpful to finding a solution to the client's current discomfort.

Why Did We Do This in the First Place?

An FLP can provide a host of benefits, some or all of which may have been motivating factors for the client. These benefits include the following:

Asset Protection

- An FLP converts potentially exposed assets (business interests, real estate, investments, etc.) to personal property interests with charging order protection. Additionally, an FLP allows the senior generation ("SG") to involve the younger generation ("YG") without exposing assets to the creditors of the family members (subject to important exceptions).

Estate Planning

- An FLP allows the SG to proportionally gift property without fractionalizing the interests in the property itself. It reduces the size of the taxable estate with lack of control and lack of marketability discounts. It also allows wealth to be transferred while control is retained.

Business Succession

- An FLP can involve the YG in ownership of a family business without fractionalizing ownership or forfeiting centralized control. It allows the SG to share economic benefits with all the YG, while providing greater control and compensation for children actively involved in management.

Asset Management

- An FLP offers centralized management of business interests and investments, which in turn may allow for cheaper fees, greater diversification, and access to certain investments and managers.

Right … But Things Have Changed

The passing of time or changed circumstances may have reduced the importance of some of the original objectives and created new problems.

Asset Protection

- Creditor threats may have diminished for the SG (i.e., after retirement from a profession with large exposure).

Estate Planning

- Diminished asset values or increases in the estate tax applicable exclusion may have reduced the need for discounts or gifting.

Business Succession

- The YG may now be mature and ready to control the assets or business.

Asset Management

- Diminished asset values may obviate the need for or benefits of consolidation.

Administrative Hassle

- The YG must calculate taxes twice (once with and once without the FLP interest) and must wait for the SG to provide the K-1 to complete their tax return. Children may not want the SG nosing around their personal finances to determine the amount of the distribution, while the SG will not want to be "billed" for the YG's loss of FAFSA eligibility or earned income credit (both common consequences of ownership of an FLP interest).

Conventional Exit Strategies Can Be Trouble

Traditional methods for exiting an FLP can be problematic. Unwinding the FLP requires the consent of all the partners and a decision to sell or distribute in-kind the FLP assets. Both forms of liquidation may cause income tax events (see IRC 704, 731, and 737). Moreover, unwinding the FLP will cause a loss of *all* FLP benefits, some of which may still be desirable (creditor protection, centralized management, etc.).

What Do We Really Want?

Focusing on the client's current objectives can reveal potential solutions to the FLP distress. In many situations, the family (both generations) would like to achieve the following:

- Maintain creditor protection
- Keep assets centrally managed
- Have flexibility in giving control to the YG
- Keep assets out of everyone's taxable estate
- Have a way to get property back to the SG
- Reduce tax return burden
- Reduce the impact on the YG's finances

In many situations, <u>all of these objectives can be achieved</u> through a properly designed irrevocable trust. In fact, the trust can enhance or exceed the benefits of the FLP. Although the partners in an FLP may generally benefit from state law charging order protection, the story is different in the case of bankruptcy. Federal law, not state law, determines the rights of the bankruptcy trustee. This "super creditor" can exercise greater rights than a normal creditor, including rights the debtor-limited partner doesn't have, such as reviewing the books and records of the FLP where the partnership agreement prohibits this. A wholly discretionary trust with spendthrift protection can offer superior protection in this regard to an FLP.

So How do I Move My FLP Into a Trust?

Numerous options are available to families that would like to achieve the objectives listed above without the hassles that accompany their FLP. In several, great care should be taken to avoid application of the "step transaction" doctrine and self-settled trust problems.

- Children might make annual exclusion gifts of their interests back to the SG, which then uses those interests to fund a trust for the YG. This can take a loooong time, though, and might require annual appraisals. In the meantime, the problems of the FLP remain.

- Children might sell their interests to the SG for a promissory note, with the SG then funding a trust for the YG with those interests. Although quicker than annual re-gifting, this would trigger recognition of built-in gain, and the family may not have the liquidity to purchase the interests (although with historically low AFRs, this might work) or might not want the YG to have the cash yet.

- Children might sell their interests for a note to IRC 678 "Inheritor's Trusts" established by the SG. This would eliminate the need to recognize gain, but ownership of the FLP would still not be consolidated and the multiple tax return and K-1 issues remain. Lack of liquidity may also defeat this option.

- Children might take advantage of their historically large applicable exclusion to gift back to the SG their entire FLP interest all at once, which the SG could transfer to a trust for the YG through gift or sale (or both). One spouse in the SG might be the recipient of the gifts, which would allow the other spouse to be a beneficiary of the trust, similar to a lifetime credit-shelter trust or spousal-access trust. If children are still minors, see Restatement (Third) of Property (Wills & Donative Transfers) §8.2 for important considerations.

The last option may be the best solution for many families who are dissatisfied with their FLP but who wish to retain many of the benefits. The end result will be that the interests in the FLP are consolidated in one trust for the family (reducing the impact on the YG's tax returns and finances), creditor protected to a greater degree than before, and outside everyone's taxable estate. A beneficial interest in the non-settlor SG spouse or a properly drafted special power of appointment, held perhaps by a trust protector, can provide a vehicle to return property to the SG and preserve flexibility for the future (absent prior agreement to this effect to avoid application of IRC 2036-2038).

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Will the YG want to cooperate? There are reasons for and against. On the one hand, the tax reporting and financial burden is lessened for the YG, while their inheritance is preserved (enhanced, even) as beneficiaries of a trust. On the other hand, the YG's interest may be less concrete or defined in the trust, and they may fear using their lifetime exclusion for gifts now without knowing what need they may have of it in the future. Many concerns can be addressed in the plan design and drafting. The loss of exclusion also has solutions, including the use of life insurance owned by the trust on the life of the beneficiaries.

Summary

Not all families have the same concerns and objectives, and FLPs vary in their design and asset mix; as a result, no one solution will fit all families. Because of the current historically large use-it-or-lose-it applicable exclusion, families who wish to retain the benefits of their FLP while reducing the administrative downsides may find a solution through use of a properly designed irrevocable trust, funded by a member of the SG with FLP interests received through lifetime gifts from the YG.

About the Author:
Geoff is a member of the Tax & Estate Planning practice section of Kirton McConkie, the largest firm in Utah. His focus is on estate, tax, business, and asset protection planning. He advises individuals and business owners on legally sound strategies to protect their assets and reduce or eliminate taxes. He counsels clients on legacy planning to maximize intergenerational wealth and reduce family stress and tension.

He graduated from BYU's J. Reuben Clark Law School, cum laude, and was named to the National Order of the Barristers. He is an adjunct professor of Business Law in the Marriott School at Brigham Young University, is an adjunct professor of Business Law and Estate Planning in the Legal Studies Department at Utah Valley University, and is the President of the Utah Valley Estate Planning Council.