

KIRTON | McCONKIE



HELP!

**I'M STUCK IN
MY FLP!**

*OPTIONS AVAILABLE TO
THOSE WHO MAY HAVE
OUTGROWN THEIR FAMILY
LIMITED PARTNERSHIP*

By Geoff N. Germane
Attorney and Counselor at Law

Why did we do this in the first place?

- Reasons for forming an FLP (FLLC)
 - Asset Protection
 - Converts exposed assets (business interests, investments, real estate, etc.) to personal property interests with charging order protection
 - Allows parents to involve other family members without exposing assets to creditors of family members (but stay tuned for **important exceptions...**)

Why did we do this in the first place?

- Reasons for forming an FLP (FLLC)
 - Estate Planning
 - Enable senior generation to proportionately gift property without fractionalizing the interests in the property
 - Reduces size of taxable estate with lack of control and lack of marketability discounts
 - Transfers wealth to next generation before transferring control

Why did we do this in the first place?

- Reasons for forming an FLP (FLLC)
 - Business Succession
 - Gets kids involved in ownership of family farm or investment properties or business without fractionalizing ownership
 - Gets kids involved without having to give up centralized control
 - Allows senior generation to share economic benefit with all children, while providing greater control and compensation for children actively involved in management

Why did we do this in the first place?

- Reasons for forming an FLP (FLLC)
 - Asset Management
 - Centralizes management of business interests
 - Centralizes management of investments
 - May allow for cheaper fees (break points), access to certain investments, access to certain managers, greater diversification, etc.

Oh yeah... but things have changed

- Reasons for wanting to get out of an FLP (FLLC)
 - Asset Protection
 - Creditor threats may have diminished for senior generation (i.e., retirement from profession with large exposure)
 - Estate Planning
 - Assets may have diminished in value
 - Increase in estate tax exemption may have reduced the need

Oh yeah... but things have changed

- Reasons for wanting to get out of an FLP (FLLC)
 - Business Succession
 - Children may have matured and are now ready to have control
 - Asset Management
 - Diminishment in asset values may obviate need for consolidation

Oh yeah... but things have changed

- Reasons for wanting to get out of an FLP (FLLC)

Administrative hassle!!!

- Children have to calculate taxes twice to determine impact of FLP interest for K-1
- Children have to wait for K-1 to do their taxes
- Children don't want M and D nosing around their personal finances to determine size of distribution
- M and D don't want to pay for lost EIC or FAFSA eligibility



Conventional options can be trouble

- Usual Exit Strategies:
 - Unwind FLP (FLLC)
 - Must get consent of all partners
 - Must identify individual to be charged with “winding up” affairs
 - Must make decision about what to do with assets

Conventional options can be trouble

- Usual Exit Strategies:
 - Sell Assets or Distribute In-Kind?
 - Both may cause income tax event (IRC 704, 731, 737)
 - Loss of all FLP benefits, some of which may still be desirable (creditor protection, centralized management, discounts, etc.)

What do we *really* want?

- In many situations, family would like to:
 - Maintain creditor protection
 - Keep assets centrally managed
 - Have flexibility in giving control (or not) to children
 - Keep assets out of everyone's taxable estate
 - Have a way to get property back to senior generation
 - Reduce extra tax returns
 - Reduce impact on children's finances

What do we *really* want? (cont.)

- Thank you for staying tuned; now a quick interlude re: creditor protection
Family does not want assets to be affected by child's divorce, bankruptcy, etc.
 - What about charging order protection?
 - What is it?
 - Does it work?
 - What about foreclosure
 - Creditor only has rights of assignee
 - Assignee cannot participate in management, vote, or exercise any rights of member



What do we *really* want? (cont.)

- Bankruptcy:

Federal law, not state law, determines BK Trustee's rights

A BK Trustee is a “super creditor” that can exercise greater rights than normal creditor

- BK Trustee steps into debtor's shoes and can exercise whatever rights the debtor has
- BK Trustee can even exercise rights debtor partner *doesn't have*, like reviewing the books and records of the FLP where the partnership agreement prohibits this!



What do we *really* want?

- Flash back to the family's objectives:
 - Maintain creditor protection
 - Keep assets centrally managed
 - Have flexibility in giving control (or not) to children
 - Keep assets out of everyone's taxable estate
 - Have a way to get property back to senior generation
 - Reduce extra tax returns
 - Reduce impact on children's finances

How do we do it?

- In many situations, these objectives can be achieved through a properly designed....
Irrevocable trust!

A *Good* Irrevocable Trust Can...

- If properly designed:
 - Give greater creditor protection than an FLP
 - Keep assets centrally managed
 - Have flexibility in giving control (or not) to children
 - Keep assets out of everyone's taxable estate
 - Have way to get property back to senior generation
 - Reduce extra tax returns
 - Reduce impact on children's finances

A Good Irrevocable Trust Can...

- Aaaaaand:
 - Keep assets private from children
 - Make all assets available to M and D during lifetime
 - Add or remove children or others as beneficiaries, and modify their interest

So how do I move my FLP into trust?

- Options: Option The First
 - Children sell their interests to M&D's trust
 - Children receive a note
 - Children are beneficiaries of the trust
 - BUT! This would trigger recognition of any built-in gain
 - FLP may not have sufficient liquidity to buy all children's interests (but with historically low AFR's, we might be able to make this work)

So how do I move my FLP into trust?

- Options: Option the Second
 - Children sell their interests to BDITs established by M&D
 - Children receive a note
 - Children are beneficiaries of their own trust
 - No recognition of any built-in gain, because the child is treated as the owner of the BDIT for income tax purposes
 - BUT! Ownership is still not consolidated, and the tax return and K-1 issues remain (multiple owners)
 - BUT again! FLP may not have sufficient liquidity to fund BDIT to buy all of a child's interests (but with historically low AFR's, we might be able to make this work)

So how do I move my FLP into trust?

- Options: Option the Third
Children gift their interests to M&D or M&D's trust with Crummey rights for M or D, using the \$13,000 annual exclusion each year
 - We do consolidate ownership (tax reporting and financial disclosure burden lessened)
 - BUT! This may take a long time, and we may need yearly appraisals
 - And if gifting straight to trust, we have self-settled trust problems
 - In the meantime, all other problems with FLP remain



So how do I move my FLP into trust?

- Options: If only there was a way to gift *more* than the annual exclusion amount to get it done all at once...

But wait! There IS!

For the rest of 2012, every man, woman, and child has a \$5.12 million lifetime gift tax exclusion

Children can gift back their entire interest all at once



So how do I move my FLP into trust?

- Options: Use \$5.12mm exemption
 - To avoid self-settled trust issues, children gift directly to M&D
 - M&D create an irrevocable trust for the benefit of children (M or D might be a beneficiary if the other is the recipient of the children's gifts, like a lifetime credit shelter trust or spousal-access trust)
 - M&D can either gift or sell the FLP interests into the trust

Does it work?

- End result?
 - All assets are protected from creditors of M&D and children
 - (if proper care is taken)
 - Assets are still inside of FLP, and are thus centrally managed
 - All FLP ownership interests are consolidated; One K-1, one tax return
 - Interest of beneficiaries can be modified, added, or removed

Does it work?

- End result?
 - Assets are outside of M&D's and children's estates
 - (if proper care is taken; beware of IRC 2036 and 2038 and “step-transaction” doctrine)
 - M&D can get assets back through four potential channels: (1) beneficial interest, (2) note payments, (3) discretionary tax reimbursements, or (4) limited (special) power of appointment
 - Assets do not impact children's EIC or FAFSA eligibility

One final piece

- If I'm a child with FLP interests, will I want to cooperate? Reasons for:
 - Increased simplicity in life (no more calculating taxes twice, waiting for the K-1, or dealing with officious parents)
 - Can maintain economic benefit (inheritance) through trust
 - Get increased protection for interest from creditors



One final piece

- If I'm a child with FLP interests, will I want to cooperate?
 - Reasons **against**:
 - Big one: use of lifetime exemption
 - What if a child has to use \$1,000,000 of exemption to get FLP interest back to parents?
 - With the estate tax exemption scheduled to go back down to \$1,000,000 (adjusted for inflation), this could create an immediate estate tax threat: child has other assets (home, bank accounts, business) but no exemption to shield them from estate tax

One final piece

- Reasons **against**: use of lifetime exemption
 - Solution: If FLP has liquidity, it can distribute to the trust and the trust can purchase **life insurance** on the life of each child, potentially with riders to add coverage as a child's assets grow in value

One final piece

- Solution: **life insurance**
 - There will be no estate tax issue unless and until the child actually dies, at which point the insurance provides the liquidity the estate needs to pay the tax
 - The trust will buy assets from the child's estate, thus transferring the assets into protected trust for the child's family

Caveats:

- Not all families have the same objectives and concerns
- Different proposed solutions may fit different families
- Asset mix of FLP will be a key to determining most appropriate solution
- Care must be taken in the design and implementation of the plan to avoid creditor and tax exposure

Thank you, Congress!

- Summary:
 - Because of the historically large current but expiring estate tax exemption, we have a tremendous opportunity to help a lot of families with FLPs that no longer meet their needs
 - Gifting back to the parents and funding a family trust can enhance the benefits of the FLP and reduce or eliminate the drawbacks

Thank you, Congress!

- One final suggestion:
 - What if the FLP (or other assets, in non-FLP scenario) has a very low tax basis and M&D would rather have it in their estate when they die for the step-up in basis?
 - Bankers to the rescue: client can get a line of credit, activated shortly before death; client makes a cash gift, which produces a deductible debt to offset the taxable value of the retained assets, which will get a step-up in basis at death

Thank you, Congress!

- Gift is \$5,000,000 (whatever the size of estate is)
- Estate is \$5,000,000
- Debt is \$5,000,000 (amount of gift from LOC)
- Taxable Estate = $\$5,000,000 - \$5,000,000 = \underline{\underline{\$0.00}}$
- Estate gets step up to FMV at death
- Asset can now be sold with NO capital gain to pay off the LOC, and \$5,000,000 is still in trust.
- Works with smaller estates and assets, as well

Thank you, UVEPC!

- Thanks to Lee
- Questions or comments?

KIRTON | McCONKIE