



# Solutions to Disenchantment With Family Entities

When "FLP" signifies "falling out of love with partnership," families should weigh their options and determine the most favorable approach to implement.

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**A**round tax season, many families with family limited partnerships or family limited liability companies (collectively referred to in this article as FLPs) experience an uptick in frustration and angst. While their FLP seemed like a great idea when it was established, it may have become onerous to administer, and oftentimes the increased cost (economic and otherwise) of administration coincides with a decrease in perceived benefits. Circumstances may have also changed since the family established its FLP. Consequently, the family may be looking for a way out. As FLPs are often formed and owned by parents and children, these relationships will be referred to in the discussion that follows for context in analyzing potential problems FLPs may encounter and solutions they may need.

Furthermore, because good planning is driven by a client's objectives, a review of the reasons the FLP was originally formed is essen-

tial to finding a solution to the client's current discomfort.

## Why was FLP formed?

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 can convert potentially exposed assets (e.g., business interests, real estate, and investments) into personal property interests with charging order protection. Additionally, an FLP allows the senior generation or parents to involve the younger generation or children without exposing assets to the creditors of the fami-

ly members (subject to important exceptions to be addressed below).

**Estate planning.** An FLP allows the parents to make proportionate gifts of property without fractionalizing the interests in the property itself. Furthermore, it reduces the size of the taxable estate with lack of control and lack of marketability discounts. It also allows wealth to be transferred and control retained.

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

**Asset management.** An FLP offers centralized management of business interests and investments,

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which in turn may allow for cheaper fees, greater diversification, and access to certain investments and managers.

### Changed circumstances

The passage of time or changes in 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 parents, such as after retirement from a profession with large exposure.

**Estate planning.** Diminished asset values or increases in the estate tax applicable exclusion (or both) may have reduced the need for discounts or gifting.

**Business succession.** The children may now be mature and ready to control the assets or business. Where the FLP was formed to begin the transition, the time may be ripe now to complete it.

**Asset management.** Diminished asset values may obviate the need or qualification for consolidation.

**Administrative hassle.** The children must calculate taxes twice (once with and once without the FLP interest) and must wait for the parents to provide the Schedule K-1 for the children to be able to complete their tax returns. Whereas the FLP may have been formed when the children were young, they may now be grown adults with careers and businesses of their own. Consequently, the children may not want the parents nosing around the children's personal finances to determine how much of a tax distribution is necessary. The discomfort here is not experienced exclusively by the children; the parents will not want to be "billed"

for the children's loss of federal student aid eligibility or earned income credit, both of which are common consequences of ownership of an FLP interest.

**Unwinding the FLP causes a loss of all FLP benefits, some of which may still be desirable (creditor protection, centralized management, etc.).**

### Conventional exit strategy problems

If the family members decide the hassle of the FLP has grown to exceed its benefit to them and they want to unwind and dissolve the entity, the traditional methods for exiting an FLP can be problematic. Unwinding the FLP generally requires the consent of at least the voting partners and a decision to sell or distribute in-kind the FLP assets. For tax reasons or otherwise, some partners may not be willing to consent. For example, the decision to sell or distribute the FLP assets may spring one or more tax traps that the family did not previously anticipate. Additionally, unwinding the FLP causes a loss of *all* FLP benefits, some of which may still be desirable (creditor protection, centralized management, etc.).

Funding, operating, and liquidating a partnership is generally more tax-neutral than with a corporation.<sup>1</sup> Transfers of property to an FLP generally do not create a taxable event,<sup>2</sup> and income from an FLP may be distributed to the owners without entity-level taxation.<sup>3</sup> Given that transfer tax concerns (estate and gift tax, primarily) are usually at the forefront of the FLP formation, little attention may be given to the income tax aspects of the arrangement. Both forms of liquidation (sell-

ing the assets and distributing the proceeds, or distributing the assets in-kind) may cause income tax events that substantially eliminate the tax benefits the family hoped to derive by use of the FLP.

### Sale of assets

The first tax trap to consider is found in Section 704(c), which provides that any gain from the sale of property that had a different fair market value from the owner's tax basis at the time of the property's contribution to the partnership must be recognized in a way that takes into account the built-in gain that existed at the time of contribution. Any additional gain from appreciation that occurred after the property was contributed is allocated in accordance with the partnership agreement if the allocation has substantial economic effect.<sup>4</sup> This is to prevent the assignment of income and the shifting of tax consequences with respect to appreciated property by virtue of its contribution to a partnership; otherwise, a partner could contribute appreciated property to a partnership and not have to recognize all the gain individually at the time of sale.

**Example.** Parents contributed real property to an FLP with a fair market value of \$500,000 and a tax basis of \$200,000. If the FLP later sells the real property, the entire \$300,000 built-in gain that the property had at the time of contribution will be allocated to and recog-

<sup>1</sup> For an excellent discussion of FLP liquidation issues, see Donaldson, "Super-Recognition and the Return-to-Sender Exception: The Federal Income Tax Problems of Liquidating the Family Limited Partnership," 35 *Cap. U.L. Rev.* 15 (2006), and Post, "Navigating the Mines and Potholes In Unwinding a Family Limited Partnership," 2010 Stanley M. Johansen Estate Planning Workshop (12/10/2010).

<sup>2</sup> Section 721(a).

<sup>3</sup> Section 731(a).

<sup>4</sup> Regs. 1.704-1(b)(2)(iv)(b), (d), and (g).



nized by the parents. Any gain from appreciation above the \$500,000 will generally be allocated pro-rata among the parents and children, according to their partnership interests. If by the time of sale the parents had transferred some of their original partnership interest to the children, the transferees of those interests will inherit the share of built-in gain that is attributable to the interest received.<sup>5</sup>

The gain recognized increases a partner's outside basis in the FLP,<sup>6</sup> and any distributions of sale proceeds are taxable to the extent they exceed the recipient partner's outside basis.<sup>7</sup> This can present several problems to the family:

- The assets may have currently depressed values, which will be locked in by selling them.
- The family may not be ready to part with the assets for non-tax reasons, as in the case of a family business.
- The family may not want to trigger the income tax consequences to the extent the sale causes them.
- The parents may not be ready to distribute cash out to the children.

### In-kind distribution of assets

If family members are not ready to sell the FLP's assets, they may hope an in-kind distribution of the assets will provide a better solution. This type of distribution of FLP assets is not without its tax pitfalls, either. Assets may be distributed in either of two ways:

1. Pro rata distributions, where each partner receives a share of

each asset in proportion to the partner's interest in the FLP.

2. Non-pro rata distributions (i.e., cherry picking), where entire assets are distributed to a partner to the extent possible.

Three different Code sections may cause a tax event on the distributions.

**To the extent money distributed to a partner exceeds the partner's outside basis in the partnership, gain is recognized.**

**Section 704(c)(1)(B) gain.** Section 704(c)(1)(B) treats as a sale a distribution of property to a partner other than the original contributor (or a transferee of the contributor's interest<sup>8</sup>) if the distribution occurs within seven years of the property's contribution to the partnership. For instance, suppose Father and Son form an FLP. Father contributes business interests worth \$2 million and a tax basis of \$200,000, while Son contributes marketable securities worth \$2 million. If the FLP distributes the business interests to Son after three years, Father will have to recognize gain of \$1.8 million.

If Father has transferred his interest to Daughter by the time the business interests are distributed to Son, Daughter will stand in Father's shoes and recognize the \$1.8 million gain.<sup>9</sup>

This gain recognition is avoided if the property is returned to the contributing partner (or transferee of the contributing partner's interest) under a "return-to-sender" exception.<sup>10</sup> So if Father has transferred his interest to Daughter and

the business interests are distributed to Daughter, no gain recognition is triggered.

Gain is also avoided if all the partners have built-in gain in proportion to their partnership interests and the partners distribute the FLP's assets pro-rata. Following up on the previous example of Father and Son, if Son's basis in the marketable securities is \$200,000 and if the business interests and marketable securities are each distributed in equal shares to Father and Son (\$1 million of each asset to each partner), no gain is recognized by either Father or Son. This is because the assets are distributed in proportion to the partners' shares of the built-in gain. Gain avoidance notwithstanding, owning a fractional interest in several assets may not be very attractive for a host of reasons which are aggravated as the number of partners grows. For instance, creditors of a fractional owner could force the sale of the whole asset to satisfy a claim, or a tenant-in-common interest might be transferred to a new owner who is unfriendly to the holdover owners.

What can be done if the family wants to avoid selling the assets but also wants to avoid distributing them in proportion to the family members' partnership interests? The first and obvious option is simply to wait seven years from the date of the property's contribution before distributing it. In some situations, the FLP will have been in existence and the property contributed longer ago than this already when the family seeks alternatives to its FLP discomfort. In other situations, the discomfort will come earlier in the FLP's life, and the family will not be willing to wait.

**Section 731(c).** Section 731(c) addresses situations where the FLP distributes only money, unrealized receivables, and inventory. The

<sup>5</sup> Reg. 1.704-3(a)(7).

<sup>6</sup> Section 705(a).

<sup>7</sup> Section 731(a)(1).

<sup>8</sup> Regs. 1.704-3(a)(7) and 1.704-4(d)(2).

<sup>9</sup> *Id.*

<sup>10</sup> Sections 704(c)(1)(B), 731(c)(3)(A), and 737(d)(1).

term “money” includes securities that are marketable (actively traded) on the date of distribution.<sup>11</sup> To the extent money distributed to a partner exceeds the partner’s outside basis in the partnership, gain is recognized. A loss is recognized only if the value of money, unrealized receivables, and inventory<sup>12</sup> distributed to a partner in liquidation of the partner’s interest is less than the partner’s outside basis in the partnership.<sup>13</sup>

For example, suppose that Father and Son form an FLP. The FLP is funded with \$100,000 in cash and \$100,000 in marketable securities from Father, and real estate with a fair market value of \$200,000 and an adjusted basis of \$50,000 from Son. If the securities were distributed to Son, he would have to recognize a gain of \$50,000—the amount by which the value of the securities exceeds his basis in the FLP.

Section 731, however, contains four exceptions. The general rule of Section 731(c)(1) does not apply if:

1. The marketable securities are distributed to the partner who contributed them (similar to the “return to sender” exception seen in Section 704).<sup>14</sup>
2. The marketable securities distributed were acquired in a nonrecognition transaction.<sup>15</sup>
3. The securities were not marketable when first acquired by the FLP and did not become marketable for at least six months after acquisition but were distributed from the FLP within five years of becoming marketable.
4. The FLP is an “investment partnership,” and the distributee partner is an “eligible partner.”<sup>16</sup>

The foregoing describes the exceptions in only very basic form, and there are further refinements and qualifications to them. Partners in

an FLP holding marketable securities who choose to tread this treacherous terrain and distribute assets in kind are well advised to make sure their map of the terrain is appropriately exhaustive in its detail.

**Children could make annual exclusion gifts of their interests back to the parents, who then use those interests to fund a trust for the children.**

Under the preceding example, if the \$100,000 in marketable securities were distributed to Father, he would not have to recognize gain because of the “return to sender” exception. But what if Father has transferred his interest in the FLP to Daughter? In many FLPs, some partnership interests have been transferred over time from the parents to the children. A transferee child partner may be able to receive property contributed by his or her transferor-parent and claim the benefit of the “return to sender” exception under Section 704(c)(1)(B), but there is no provision for a similar extension of the “return to sender” rule of Section 731(c).<sup>17</sup> Because the recognition rule of Section 731(c) does not expire after seven years, waiting does nothing to cure this.

If Section 731(c) applies, the “deemed” distribution is calculated by a formula that causes the distributee partner to recognize gain on all but that partner’s share of the gain in the distributed securities. The formula computes the deemed cash distribution by (1) determining the distributee’s share of the net gain on the sale of *all* the FLP’s marketable securities and (2) subtracting from that the dis-

tributee’s share of the net gain on the sale of the marketable securities *retained* by the FLP. The excess of (1) over (2), if any, is subtracted from the fair market value (FMV) of the securities distributed as long as it does not reduce the FMV below zero.

**Example.** Father, Mother, and Son form an FLP. Father and Mother contribute marketable securities A and B, respectively, with an FMV and basis of \$200,000. Son contributes marketable security C with an FMV and basis of \$200,000. Father and Mother then transfer a quarter of each of their FLP interests to Son (\$50,000 from each) and the rest to Daughter (\$150,000 from each), leaving Daughter and Son as equal partners. Security A decreases in value to \$160,000, security B increases in value to \$210,000, and security C increases in value to \$260,000. The FLP distributes security B to Daughter.

Had all the securities been sold, the FLP would have realized a gain of \$30,000 (a loss of \$40,000 on A, a gain of \$10,000 on B, and a gain of \$60,000 on C), of which Daughter’s share would have been \$15,000. The FLP’s gain on the retained securities, A and C, would have been \$20,000, of which Daughter’s share would have been \$10,000. The excess of Daughter’s share of the overall gain over her share of the gain in the retained securities, then, is \$5,000. Using the formula above, the deemed cash distribution to Daughter is the FMV of the distributed securities (\$210,000), less this excess of

<sup>11</sup> Section 731(c)(1).

<sup>12</sup> These latter two are defined in Sections 751(c) and (d).

<sup>13</sup> Section 731(a)(2).

<sup>14</sup> Section 731(c)(3)(A)(i).

<sup>15</sup> Reg. 1.731-2(d)(1)(ii).

<sup>16</sup> Section 731(c)(3)(C)(iii); Reg. 1.731-2(e)(2)(i).

<sup>17</sup> Reg. 1.731-2(d)(1).



\$5,000. Thus, while Daughter is receiving only a security back from the FLP, she may be treated as having received \$205,000 in cash.

If Son were to receive security C in a distribution, the “return to sender” exception would prevent the security from being treated as a cash distribution triggering gain recognition. Because this exception does not apply to a successor-in-interest, however, Daughter may not enjoy the same benefit.

**Section 737.** To prevent the use of a partnership as a vehicle through which tax-free exchanges of property with built-in gain could occur, Section 737 requires recognition by a distributee partner of the lesser of (1) the Section 704(c) built-in gain and (2) the excess of the distributed property’s value (other than money) over the distributee’s outside basis in the partnership immediately before the distribution. In this calculation, the outside basis is reduced (but not below zero) by any money received in the distribution. Loss is not recognized, and is instead generally applied to the basis of the distributed property.<sup>18</sup> This section does not apply to distributions to a partner of property contributed by that same partner<sup>19</sup> (another “return to sender” exception), but the Code and regulations are again silent on whether this exception can be claimed by a contributing partner’s successor-in-interest.

The general rule of Section 737, however, *does* apply to a partner’s assignee. Thus, if Father contributes appreciated real estate to an FLP and then transfers his FLP inter-

est to Daughter, Father’s built-in gain in the real estate will be recognized by Daughter if she receives a distribution of closely held business interests from the FLP,<sup>20</sup> provided this gain is less than the excess of the distributed property’s value over Daughter’s basis in the FLP.<sup>21</sup>

Similar to Section 704(c)(1)(B), the gain under Section 737 can be avoided if the FLP property is returned to the contributing partner, or if the FLP waits seven years after contribution to make the distribution.<sup>22</sup> Without the aid of a “return to sender” exception for transferees of partnership interests, however, the first escape hatch may not be available if the FLP interests have changed hands from the parents to the children.

**If the children held only limited partner interests in the FLP, no control is lost over management of the assets by the FLP-to-trust transactions.**

#### *Sorting and summary of tax traps.*

If a distribution of property triggers application of more than one of the preceding three Code sections, the regulations provide that Section 701(c)(1)(B) is applied first, then Section 731(c), and finally Section 737.<sup>23</sup>

Application of Section 704(c)(1)(B) requires that a contributor of partnership property recognize built-in gain or loss if that property is distributed to another partner within seven years of contribution. This section contains a “return to sender” exception that also extends to a partner’s assignee.<sup>24</sup>

Application of Section 731(c), secondly, requires recognition of gain to the extent the deemed dis-

tribution of marketable securities (treated as cash) exceeds the distributee’s outside basis in the partnership immediately before the distribution. The contributing partner enjoys a “return to sender” exception, but no provision exists for this exception to be claimed by the partner’s assignee.

Lastly, application of Section 737 causes a contributing partner to recognize built-in gain (but not loss) from contributed property if the contributing partner receives a non-cash asset other than the contributed property within seven years of contribution. The “return to sender” exception of Section 737 is not specifically extended to an assignee.

The application of these rules to a given FLP may or may not create consequences the family will want to avoid. In the forced gain recognition situation where assets are distributed in-kind, the lack of liquidity to pay the necessary tax could be problematic. Selling the assets to either distribute the liquid proceeds or to have funds with which to pay taxes will also substantially eliminate the tax and non-tax benefits the family hoped to realize by employing the FLP.

#### **Alternatives to terminating the FLP**

Some (or all) of the objectives the family had when setting up the FLP may remain relevant. A focus on the family’s current objectives can reveal potential solutions to the current problems. In many situations, both generations of the family want to achieve the following:

- Maintain creditor protection.
- Maintain central management of the assets.
- Enjoy flexibility in giving (or not giving) control to the children.

<sup>18</sup> Sections 723 and 732(a)(1).

<sup>19</sup> Reg. 1.737-2(d)(1).

<sup>20</sup> Reg. 1.731-1(c)(2)(iii).

<sup>21</sup> Section 737(a).

<sup>22</sup> Section 737(b)(1).

<sup>23</sup> Reg. 1.731-2(g)(1)(i).

<sup>24</sup> Reg. 1.704-4(d)(2).

- Keep the assets out of everyone's taxable estate.
- Have a way to get the assets back to the parents.
- Reduce the tax reporting burden.
- Reduce the impact on the children's finances.

In many situations, *all of these objectives can be achieved* 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,<sup>25</sup> 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 does not 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 to an FLP in this regard.

### Moving an 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.

- Children could make annual exclusion gifts of their interests back to the parents, who then use those interests to fund a trust for the children. This can take a long time, however, and might require annual appraisals. In the meantime, the problems of the FLP remain.
- Children could sell their interests to the parents for a promissory note, with the parents then funding a trust for the children 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 or want the children to have the cash just yet. Historically low AFRs, however, might increase the economic feasibility of this strategy.

- Children might sell their interests for a note to Section 678 "inheritor's trusts" established by the parents. This would eliminate the need to recognize gain, but ownership of the FLP would still not be consolidated, and the multiple tax return and Schedule 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 their entire FLP interest to the parents, all at once.<sup>26</sup> The parents could later transfer the now-consolidated FLP interests to a trust for the children through gift or sale (or both). One of the parents alone might be the recipient of the gifts, which would allow the other parent to be a beneficiary of the trust, similar to a lifetime credit-shelter trust or spousal-access trust.

For each of these options, great care should be taken to avoid application of the "step transaction" doctrine and self-settled trust problems.

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 of this course of action will be that the interests in the FLP are consolidated in one trust for the family (reducing the impact on the children'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-set-

tlor parent or a properly drafted special power of appointment, held perhaps by a trust protector, can provide a vehicle to return property to the parents and preserve flexibility for the future (absent prior agreement to this effect to avoid application of Sections 2036 through 2038).

The tax traps that are inherent in this solution merit further examination.

**Step-transaction doctrine.** This judicial doctrine seeks to collapse several discrete steps into a single transaction for tax purposes. Applied to the FLP-to-trust solution, this doctrine could recast the separate transfer of FLP interests from the children to parents and then the creation and funding of a trust by the parents for the children as a single transaction for tax purposes in which the children in essence form a trust for themselves, funding it with their FLP interests. This treatment creates self-settled trust problems, of course, particularly if the trust is formed in a jurisdiction that either does not recognize self-settled trusts or that imposes requirements on such trusts that are not satisfied by the trust holding the FLP interests. At a minimum, the risks raised include creditor exposure and estate inclusion.

These results can be avoided if the step-transaction doctrine does not apply. The doctrine has historically been invoked by any of three different tests:

1. The "end result test."<sup>27</sup>
2. The "interdependence test."<sup>28</sup>

<sup>25</sup> Many states do not limit a creditor's recourse to a charging order and also provide that foreclosure of the FLP interest is a possible remedy.

<sup>26</sup> If some children are still minors, see Restatement (Third) of Property (Wills & Donative Transfers) § 8.2 for important considerations.

<sup>27</sup> Kornfeld, 137 F.3d 1231, 81 AFTR2d 98-907 (CA-10, 1998).

<sup>28</sup> Associated Wholesale Grocers, Inc., 927 F.2d 1517, 67 AFTR2d 91-837 (CA-10, 1991).

