Asset Protection Planning and the Family Limited Partnership

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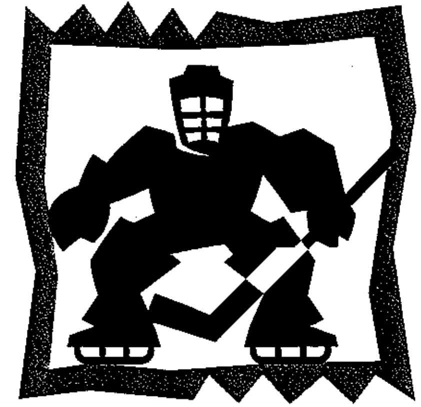

One of the most compelling reasons for using a family limited partnership (FLP) is to protect assets from the ravages of tort creditors. Our legal system has witnessed an explosion of tort and product liability litigation, and it encourages the filing of frivolous claims. The huge cost of defending these claims may force the target to make a generous settlement or otherwise find itself at the wrong end of a multimillion-dollar judgment.

Asset protection planning is necessary to ensure that assets, which have taken many years and hard work to accumulate, are not lost in the litigation craze. The FLP is an excellent device to accomplish this desired effect. The FLP is unusual in that its assets are not subject to any claims creditors may have against a partner. Therefore, if the partner transfers all of his or her assets to an FLP, those assets are protected from the partner's creditors. The FLP legal structure in effect penalizes creditors who decide to take over the partner's position in the FLP.

Limited Liability and Nonparticipation in Management

An FLP is formed under a state's limited partnership law. Most of the state statutes, including the New York law, are based upon a uniform act known as the Revised Uniform Limited Partnership Act (RULPA).

The limited partnership was created to accomplish two basic purposes: (1) to limit the liability of partners not engaged in active management of the business, and (2) to avoid participation in the management of the partnership by those who are passive investors. In a limited partnership, a limited partner's liability is limited to his or her agreed capital contribution. Limited partners do not participate in the management of the partnership. That activity is vested solely in the general partner.

Asset Protection Planning and the Charging Order

RULPA limits the remedies that a judgment creditor has against the debtor's partnership interest. RULPA Sec. 703 limits the rights of judgment creditors to obtaining a court charging order against the interest of the partner. To the extent so charged, the judgment creditor has only the rights of an assignee. An assignee is not a partner and is only entitled to receive distributions to which the assignor was entitled.

Observation

Since family members control the FLP, once a judgment creditor obtains a charging order, the general partner will cease all distributions so that nothing is paid to the creditor.

Limited Rights of an Assignee

An assignee may become a limited partner only if the assignor gives the assignee that right in accordance with the partnership agreement or all the partners consent. Since an assignee is not a partner, the assignee does not have any right to withdraw from the partnership or the right to vote or acquire the debtor's FLP interest.

The sum and substance of the RULPA provisions is that the most a judgment creditor of a partner may expect to receive is a charging order against the debtor's interest in the partnership. Even if the debtor wanted to give the creditor the right to become a limited partner, the partnership agreement may prohibit that by imposing a consent requirement by all the partners or a specified percentage of the partners.

Creditor Income Tax Trap

Even though the creditor may have a charging order against the debtor's interest, that order may be of no value to the creditor unless partnership distributions are greater than the tax liability. Under an Internal Revenue Service ruling (Rev. Rul. 77-137, 1977-1, CB 178), an assignee is treated as a substituted limited partner for Federal income tax purposes. This means that the judgment creditor must report as income the distributive share of all partnership items (i.e., income, gain, loss, deduction) attributable to the charged interest.

It is therefore possible that a judgment creditor with a charging order could wind up with a tax liability that severely limits the value of the order or even renders it unattractive. To the extent that distributions are less than taxable income, the value of the judgment is eroded.

Observation

The partnership agreement should provide that the general partner may retain earnings to the extent required for its reasonable business needs (i.e., expansion, investment, or as reserves to fund debt repayment). These retained earnings will constitute income to the assignee as well as the other partners. The idea is that the potential tax liability may serve to discourage judgment creditors from seeking charging orders.

Observation

Often, senior family members transfer business interests to junior family members. When these transfers are in the form of FLP limited partner interests, the same protection is afforded to the junior family members as is afforded to any other limited partner. This protects the assets from the child's creditors. If assets were transferred directly to a child, the child's judgment creditors could seize those assets.

Conclusion

The FLP is an excellent device for protecting the assets of a partner. If the partner's assets are owned by an FLP, so that the partner owns only FLP interests, creditors of the partner are limited to obtaining a charging order against those interests. The charging order, while it permits the creditor to receive distributions, if they are declared, also saddles the creditor with the tax liability. This renders the charging order unattractive. As a practical matter it is rarely used.

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