RODRIGUEZ LAW, P.C.

ASSET PROTECTION PLANNING

FAMILY LIMITED PARTNERSHIPS

in New York

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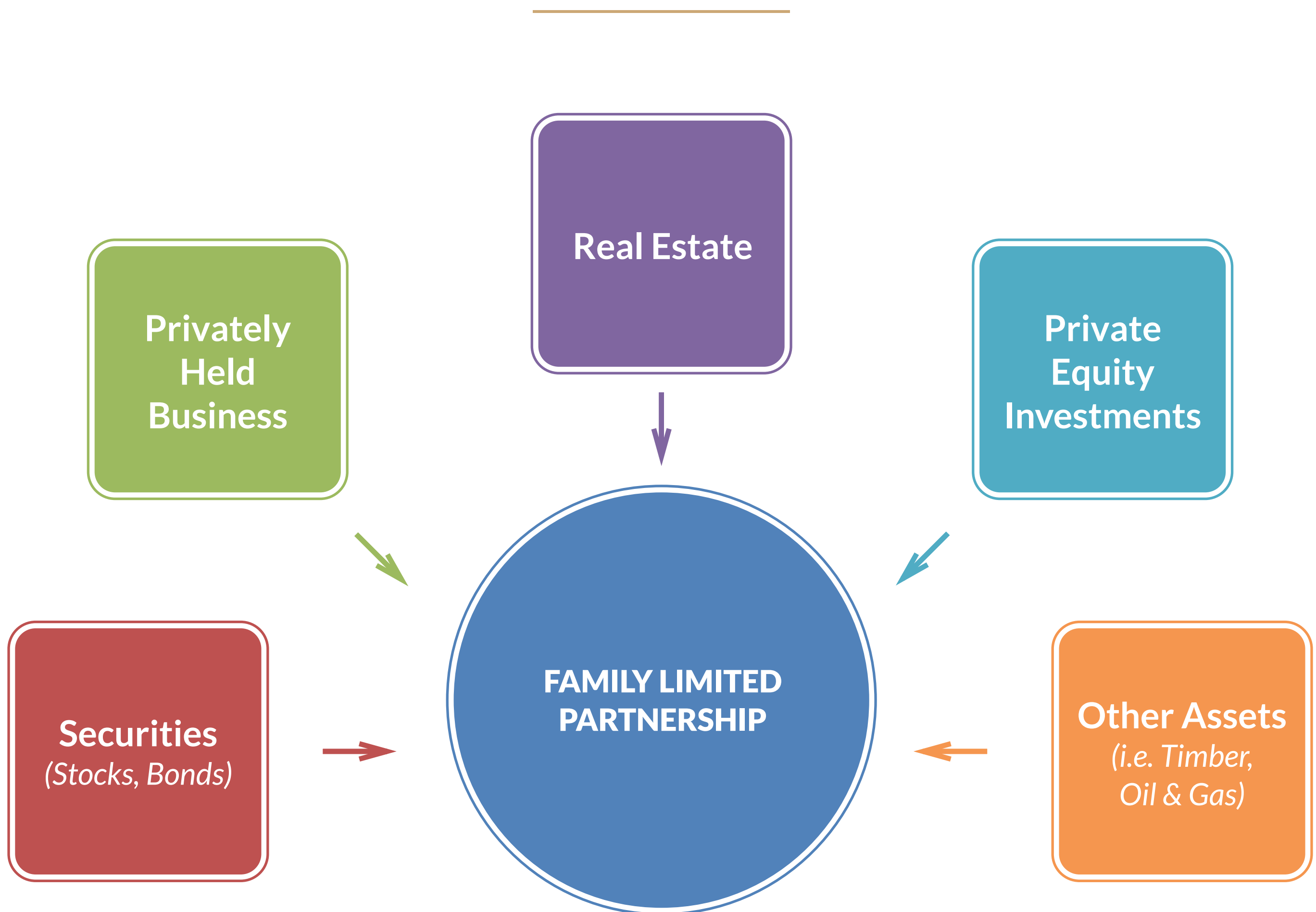
Many small business owners are unaware of the risks associated with direct ownership of their businesses. While direct ownership ensures sole control of business decisions and 100% share of the profits, it also exposes the owners to liability for any potential lawsuits, whether against the business or the individual owners. In the event of a large damages award against a directly-owned business, the owners risk losing all the business assets, including real estate, licenses to operate, inventories, equipment, and other business assets. For family-owned businesses, the risks of direct ownership could lead to losing the very livelihood of an entire family.

Generally, a family limited partnership (FLP) can protect assets against lawsuit judgments by exchanging direct ownership of the assets for a partnership interest in the partnership that the assets create. A FLP can also lower a business owner's taxes because it is a "pass-through entity." That means that any income generated by the partnership "passes through" to the individual partners, and is taxed individually. This is in contrast to another common business structure, the "C corporation," which allows for double taxation because the business itself must file and pay taxes at the "corporate level" and then the individual business owners must pay taxes on whatever income they receive individually from the business.



OVERVIEW

A family limited partnership (FLP) is a tool that family-owned businesses can use to achieve the goals of protecting assets, preserving control, and saving taxes. Depending on the particular circumstances, it may be beneficial for a husband and wife to title most, if not all, of their assets in a family limited partnership. The husband and wife would each hold a ½ percent interest as **general partners**, and a 49.5 percent interest as **limited partners**. The general partner role controls all business decisions, and the limited partner role contributes capital to invest in the business, but does not enjoy the rights of managing the business or face any personal liability for the partnership's obligations. In the event of a successful lawsuit against either the husband or wife, the **judgment creditor** would not be able to seize the assets in the FLP. Instead, the judgment creditor is limited to seeking what is known as a **charging order**.

Charging Order Protection

The FLP offers protection against charging orders because the charging order only requires that future payments intended to go to the debtor partner be diverted to the judgment creditor. The charging order does not require the partnership to make any payments to its partners; that is a business decision that remains in the discretion of the general partners.

Phantom Income to Judgment Creditor

The FLP can also lead to "phantom income" for a judgment creditor because any income from the partnership that is due to a partner becomes income that a creditor who obtains a charging order will have to declare. This is true whether or not a distribution is made to a debtor partner and diverted to the judgment creditor under a charging order. Thus, holding assets in a FLP is a step that itself deters judgment creditors from seeking a charging order in the first place.

Charging Order as Sole Remedy

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Asset-Level Tax Pitfalls

Deciding what assets to transfer into a FLP requires careful attention because transferring certain types of assets to a FLP can have the effect of increasing individual taxes. For example, transferring a personal residence to a FLP can disqualify mortgage interest from being a deduction on an individual's taxes. In addition, eligibility for the $250,000 taxable gain exclusion for the sale of a principal residence could be lost depending on the timing of transfer into or out of a FLP. Other considerations apply to assets such as stock in **S corporations** and **annuities**.

Partnership Level Tax Pitfalls

Deciding what assets to transfer into a FLP could also affect the rules that apply to the FLP, and ultimately the tax burden on the partners. For example, if 80% or more of the FLP's fair market value is comprised of diversified, marketable securities, the FLP can be classified as an investment company. Additionally, if a partner's contribution to the partnership results in debt relief, the partner may face adverse tax consequences if there is a recognized gain that results. This usually arises when real estate subject to a mortgage is transferred to a partnership, and the debt obligation is thus spread among the general partners. Similar recognized gains can result at the dissolution of the FLP.

Divorce Issues

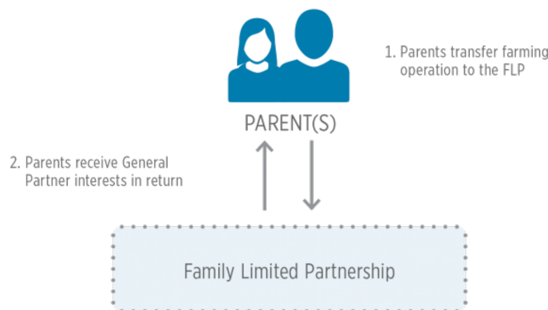
There are unique marital law implications when an FLP is comprised of husband and wife partners, particularly when each spouse contributes *separate* property of differing values to the partnership in exchange for equal partnership interests. There is also a potential for conflicts of interest when both spouses are represented by the same attorney.

Charging Order Protection, Real Estate, and Other Non-Liquid Assets

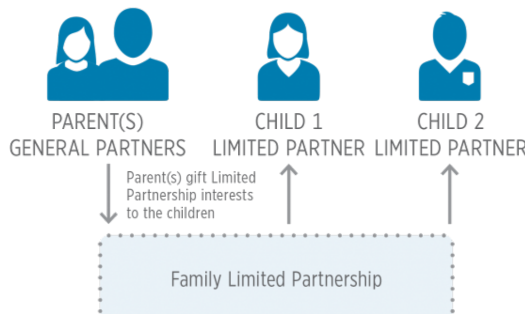
Because the FLP provides the benefit of charging order protection (albeit short-term in New York), it can be the primary tool for asset protection. This is particularly true when real estate, other immovables, and/or intangibles form a large portion of the assets sought to be protected.

Family Limited Partnership

For example, Parent(s) set up a FLP and transfer farming operation assets into the partnership.



Then, Parent(s) gift Limited Partnership interests to the children.



CHARGING ORDER PROTECTION

When a plaintiff wins a lawsuit and the court awards money, the plaintiff becomes a **judgment creditor** and the losing defendant becomes a **judgment debtor**. The judgment creditor will typically seek to have the judgment debt paid from whatever valuable assets the judgment debtor has, including business-related assets such as real estate, licenses to operate, inventories, and equipment. A business owner can transfer these kinds of assets into a FLP, with the result that the business owner no longer directly owns the assets, but rather has exchanged the assets for a partnership interest in the newly formed FLP. This means that the judgment creditor cannot go directly after the assets owned by the FLP, but rather must seek a **charging order** against the judgment debtor's partnership interest in the FLP.

A charging order is a court order that a judgment creditor can obtain to charge the debtor partner for payment of the unsatisfied amount of the judgment plus interest. The charging order is similar to wage garnishment in that any future payments that would be made to the debtor partner from the partnership are instead made to the judgment creditor who obtained the charging order, until the judgment debt is paid off. Importantly, the judgment creditor who obtains the charging order does not gain any rights in the partnership interest; the charging order only grants the judgment creditor the benefit of receiving payments made from the partnership to the debtor partner.

In practice this means that the charging order has no impact on the control general partners have over the partnership. General partners make all decisions for the FLP, including the decision as to if and when payments are made from the partnership to its partners. In this sense, the FLP offers substantial protection against charging orders. Typically, the general partners will decide to suspend making any distributions from the FLP when faced with charging orders. Of course, this means that while the judgment creditor does not receive any payments until the general partners authorize a distribution, neither does the debtor partner. In this way, a FLP is more of a short-term asset protection tool.

PHANTOM INCOME TO JUDGMENT CREDITOR

Partnerships, including FLPs, are not taxable entities but rather a reporting entity. Indeed, a major benefit of the FLP is avoiding double tax liability as compared to arranging a business as a C corporation. In a FLP, each partner must report his or her share of profits or losses derived from the partnership, whether or not the partner actually received any money. Any income earned by the partnership flows through to its partners and is income that the individual partners have to declare on their taxes. If a partner is subject to being taxed on undistributed profits of the partnership, then a judgment creditor of the partner is also subject to being taxed. This is because the IRS considers a creditor who obtains a charging order to be the economic successor in interest to the involuntary debtor partner.

CHARGING ORDER AS SOLE REMEDY

Under New York Partnership Law Section 111, the charging order is not the exclusive remedy available to a judgment creditor against a debtor partner. Beyond the charging order itself, a court can "make all other orders, directions, and inquiries which the circumstances of the case may require." N.Y. Partnership Law § 111(1). For example, courts have ordered the sale at auction of a partnership interest following an unsatisfied charging order, wherein the proceeds of the sale would go to the judgment creditor. Nevertheless, the purchaser of a partnership interest at public auction only acquires the partner's share in the partnership profits, and not any right to participate in partnership decisionmaking. To be clear, the forced sale of a partnership interest means that the debtor partner whose interest was sold at auction would have to buy back the interest from the purchaser if he wants to regain that partnership interest. In this sense, the FLP functions as a short-term asset protection vehicle.

In deciding whether to form a FLP, business owners must be careful to ensure the appropriate operation of the partnership as a separate entity from those who transferred assets into the partnership. The concept of respecting this separateness is a key question that courts consider in petitions for charging orders, particularly if it is clear a FLP was used primarily as an asset protection vehicle. Bad practices such as signing contracts in an individual rather than in a general partner capacity, failing to hold regular meetings with minutes, or paying personal expenses from partnership funds can all persuade a court to find that a partnership was a sham, alter ego, or agent of the transferors who formed the partnership. Such a finding means the FLP was never valid, and a judgment creditor could go directly after the assets thought to be held and thought to be protected by the FLP.

ASSETS WITH NEGATIVE TAX CONSEQUENCES

Negative federal tax consequences will result if S corporation stock, annuities, or a personal residence are transferred to a FLP. S corporations are similar to FLPs in that they are also "pass through" entities that avoid double tax liability. However, because only a natural person (and certain trusts) can own S corporation stock, FLPs are not permitted to own S corporation stock. I.R.C. § 1361(b)(1)(B). Transferring S corporation stock to a FLP will destroy the S corporation election, leaving the corporation to be taxed as a C corporation and triggering double tax liability. In a similar vein, only natural persons can receive the tax-deferral benefits of an annuity. (Code Sec. 72(u)). Therefore transferring an annuity into a FLP disqualifies the tax-deferral and completely defeats the benefit of having purchased the annuity.

When deciding whether to transfer a personal residence into a FLP, a business owner must be aware of (1) the requirements to qualify for the mortgage interest deduction on personal income taxes, and (2) the rules for the taxable gain exclusion for the sale of a personal residence.

Mortgage Interest Deduction

The IRS code allows a mortgage interest deduction on personal income taxes for "qualified residences." (Code Sec. 163(h)(3)). In order to be a qualified residence, the person who occupies the residence must also be the owner of the residence. Because technically under a FLP the partnership and not the occupant is the owner, there is a risk that the deduction for mortgage interest will not apply. Even if there is no mortgage on a residence a business owner wants to transfer to a FLP, the business owner should think carefully of any possible future need to get a mortgage on the property.

Taxable Gain Exclusion

The IRS code allows for up to $250,000 (or $500,000 for a married couple) of any gain from the sale of a principal residence to be to be exempted from taxable income. However, in order to qualify for this taxable gain exclusion, the individual(s) selling the residence must have (a) owned the residence for at least 2 of the 5 years prior to the date of the sale, and (b) lived in the residence as their principal residence for at least 2 of the 5 years prior to the date of the sale. Additionally, for the two-year period ending on the date of the sale, an individual seeking the taxable gain exclusion must not have excluded gain from the sale of another residence. The two-year "ownership" and "use" requirements do not have to be continuous, nor do they have to occur at the same time. Therefore there is some flexibility in qualifying for the taxable gain exclusion, but careful planning is still necessary when deciding when to transfer a personal residence into or out of a FLP.

PARTNERSHIP TAX PITFALLS

In addition to the tax consequences already discussed, there are other situations at the partnership level that can lead to increased tax liability. These scenarios involve calculations of the fair market value of assets and the **adjusted basis** of assets and partnership interests in the FLP. Adjusted basis is the value of an asset or partnership interested discounted by the costs of obtaining and maintaining the asset. For example, if a partner owns real estate with a fair market value of $100,000, spent $5,000 in purchase costs (including title and escrow fees, commissions, sales tax, etc.), and spent another $20,000 improving the property, the adjusted basis is $100,000 - $5,000 - $20,000 = $75,000.

Investment Company Pitfall

Transferring marketable and diversified securities into a FLP can cause the partnership to be classified as an investment company, if certain requirements are met. The FLP can be treated as an investment company when (1) marketable securities, such as stock traded on an exchange, are transferred to a partnership by a partner; (2) as a result of the transfer, there is a diversification of securities held by the partnership; and (3) after the transfer, marketable securities represent more than 80 percent of the fair market value of the FLP. I.R.C. § 351(e)(1), Treas. Reg. § 1.351-1(c)(1)(i)–(ii). The result is that the transfer is treated as a transfer to an investment company, and individual taxable gain is calculated as the difference between the respective fair market values and adjusted bases of the marketable securities transferred. For example, if a husband transfers $1 million worth of GM stock with an adjusted basis of $500,000 to an FLP, and his wife transfers $100,000 worth of IBM stock with an adjusted basis of $10,0000, each will be forced to recognize gains. The husband's taxable gain would be $500,000 and the wife's taxable gain would be $90,000. While there are various methods of avoiding this investment company pitfall, careful planning is required because any assets left outside of the FLP will be reachable by judgment creditors.

Net Debt Relief Greater than Basis Issue

If a partner contributes an asset to a FLP that is subject to a debt, and the debt obligation is transferred from the contributing partner to the partnership itself, the contributing partner assumes a share of the partnership's debt obligation on that asset based on his partnership interest. Because the transferring partner is relieved of individual debt liability in such a transfer, the value of the debt is a **deemed distribution**. Whatever increase in the contributing partner's share of partnership debt liability is a **deemed contribution**. If the value of the net deemed distribution is higher than the partner's adjusted basis in his or her partnership basis, the difference will be a recognized gain for the contributing partner. In other words, the transfer of an asset subject to a debt from a partner to a partnership has the effect of lowering the contributing partner's debt obligation. If that debt relief is worth more than the contributing partner's adjusted basis interest in the partnership, the contributing partner has a recognized gain that can increase his tax liability.

Distribution of Marketable Securities Issue

Tax issues can arise at the dissolution of a partnership, if marketable securities are distributed to a partner other than the partner who originally contributed those securities. Such distributions are treated as money for purposes of determining whether there is a recognized gain. I.R.C. § 731(c). As with the net debt relief issue, a gain is recognized when a deemed distribution of money is greater than the partner's adjusted basis in the FLP.

DIVORCE ISSUES

New York State distinguishes between **separate property** and **marital property** when dividing assets between divorcing spouses. Only marital property, typically property or earnings acquired during a marriage, will be equally divided between the divorcing spouses. Separate property, which includes property acquired prior to the marriage (even if subsequently exchanged for something else of value, as in the formation of a FLP), is not subject to division. If a spouse contributes separate property of greater value than the assets contributed by the other spouse, and both get an equal interest in the FLP, a domestic relations court is likely to treat the excess interest one spouse received as his or her own separate property in the form of a gift. Therefore, spouses forming a FLP must carefully consider what assets to contribute in the formation of the FLP, with a clear understanding that unequal contributions to the partnership, even of separate property, are likely to be treated as a gift to the other spouse not subject to division in a divorce.

The possibility of divorce also presents possible conflicts of interest. In a divorce, each spouse seeks out his or her own attorney, but the FLP of which both spouses are partners is represented by a single attorney whose clients are both spouses. Even if a FLP is formed only with marital property that is subject to equal division in the event of a divorce, the possibility of conflict of interest remains because both spouses must consent to the transfer of community property into a FLP.

CHARGING ORDER PROTECTION, REAL ESTATE, AND OTHER NON-LIQUID ASSETS

Despite the limitations and potential issues that can arise in a FLP, it is still a strong asset protection vehicle. This is particularly true when the assets held in the FLP are relatively illiquid and of high value (such as real estate, an operating company, etc.), so as to warrant special consideration in asset protection planning.