

Overview on How Family Limited Partnership Creditor-Proofs your Assets

The limited partnership has become the cornerstone for protecting domestic (U.S.-based) assets for several reasons. With the limited partnership, you can maintain complete control over your assets as the general partner and indirectly own the assets through ownership of a limited partnership interest. Correctly drafted, assets transferred to the limited partnership become fully protected and beyond the reach of any future creditor, including the IRS and other governmental claimants. Most asset protection attorneys share our view that the limited partnership and the LLC are generally the most advantageous domestic entities for protecting assets. This is why they are the foundation for safeguarding assets within the United States. When considering the limited partnership for protection, the two central questions are:

1. How does a limited partnership protect assets?
2. How much protection does a limited partnership provide?

To answer these questions, understand the specific rights and limitations of a partner's personal creditor when that partner's assets are protected through ownership in a limited partnership. Generally, a creditor of a limited partner can attempt to seize only three types of assets:

- Limited partnership interest
- Profits or distributions payable to the limited partner
- Assets previously transferred to the limited partnership by that debtor-partner

Let's examine each possibility:

1. Seizure of the Limited Partnership Interest

A creditor of a limited or general partner cannot seize the limited partnership interest. A judgment creditor of a limited partner can only have the court issue a charging order against the limited partnership interest. The charging order gives the creditor only the right to claim profit or liquidation distributions payable to the limited partner.

The charging order does not make the creditor a substitute partner. Nor does it give the creditor any partnership rights, except the right to claim profits or distributions payable to the debtor-partner. The creditor cannot sell or auction the partnership interest, nor can the creditor vote as a limited partner or inspect the partnership books. In sum, the creditor becomes only an assignee of the limited partnership interest for the purposes of collecting profit distributions voted by the general partners and paid to the limited partner.

The charging order's central purpose is to protect the partners that are uninvolved in the debts of the debtor-partner from any undue interference in the affairs of the partnership by that creditor. This is distinguished from a typical corporation where a shareholder's creditors can force the sale of the debtor-shareholder's shares. The buyer of the shares becomes a successor stockholder with

all the rights of a stockholder. This one distinction makes the limited partnership highly useful for safeguarding wealth.

2. Seizure of Profits or Liquidation Distributions

If the creditor's right to claim distributed profits or liquidating proceeds due the debtor-partner is the sole remedy, how practical is that remedy? Consider its limitations. First, partnership profits can be illusive, particularly when the limited partnership is family-owned or the interests of the partners are closely aligned. This is the case for most limited partnerships. Second, the decision of distributing profits belongs exclusively to the general partners. The creditor cannot force a distribution.

The limited partnership can simply defer profit distributions until the charging order creditor loses patience and settles. Nor will this deferral strategy necessarily deprive the debtor-partner access to partnership funds. The debtor-partner may accept loans, salaries, consulting fees, or payments for other assets he may sell to the limited partnership. The debtor-partner can also divert profits to other interconnected entities that may transact business with the limited partnership. They thus become a protected conduit for partnership earnings. These funds would not be subject to the charging order because they are not a distribution of profits.

Third, you can structure your limited partnership to allocate a higher percentage of the profits to the other partners, who nevertheless may own a lesser percentage of the partnership. You may own, for example, 90% of the limited partnership but be entitled to only 10% of its profits. This 10% would be the only vulnerable profit distribution. The opportunities are endless to defeat the creditor from ever receiving partnership profits. A creditor awaiting profit distribution can be in for a long, frustrating, profitless wait.

The ability to frustrate a creditor is not so easy if you are only a minority limited partner in a limited partnership with hundreds of investors and an unaffiliated general partner whose interests and agenda may not parallel that of yourself as the debtor-partner. If a partnership generates a constant and substantial profit stream, the creditor's charging order will produce payment. The debtor-partner's only option is then to sell or encumber his partnership interest, or assign future partnership profits to another protected entity.

A creditor is in a far better position when the debtor-partner cannot control or influence the distribution of profits, such as when the limited partnership includes large numbers of unrelated partners. A 2% debtor-partner who receives consistently large cash dividends will lose those dividends to a charging order creditor. In this instance, the limited partnership becomes far less advantageous an asset protector. Despite this fact, there is a simple strategy that allows us to overcome this problem: We place your minority interest in another limited partnership to which you are a majority partner (this, of course, should be done before creditor threats arise). Although the larger partnership may make distributions, the distributions will go to another protected entity. Distributions may then be withheld.

Few creditors get a charging order, for one good reason: The charging order creditor becomes liable to pay the taxes on partnership profits allocable to the debtor-partner—even when the creditor receives no payment or profit distributions from the partnership.

Consider a creditor holding a charging order against a limited partner with a 50% partnership interest. If the partnership earns \$100,000 in a particular year, \$50,000 is allocated to the debtor-partner, who would pay the taxes on this \$50,000. Instead, the charging order creditor assumes the partner's tax liability - whether or not the creditor receives the distribution. A creditor in a 35% tax bracket has a \$17,500 tax bill each year the charging order is in effect and the debtor-partner has similar allocable profit. Meanwhile, because no profits have been actually distributed, the creditor has a \$17,500 tax liability and has received no cash. Conversely, the debtor would have \$50,000 tax-free retained earnings within the limited partnership.

Under IRS Revenue Rule 77-137, the tax obligation falls entirely on the charging order creditor. The creditor, not the debtor-partner, receives the K-1 reported to the IRS. Some states even prohibit a charging order creditor from releasing the charging order without the consent of the debtor-. Thus, the charging order cannot reasonably be seen as an effective weapon, but more realistically as a device that can give the creditor only a tax bill instead of a payment. It is important to note that there is some debate among the professional community as to whether the mere holder of a charging order may be liable for the debtor's share of partnership liability. This is because IRS Revenue Ruling 77-137 states that only an assignee of partnership interest that holds complete dominion and control over the interest would be liable for the debtor's payments on partnership liability. Fortunately, an immaculately drafted partnership agreement will allow the general partner to transfer voting and other rights to the creditor, without jeopardizing the partnership or the debtor's partnership interest. This insures that the debtor's share of tax liability will properly flow to the creditor. Regardless, there is nothing that would prohibit a general partner from sending a K-1 to the creditor. The mere possibility of a tax liability for undistributed profit serves as a prohibitive deterrent against a creditor obtaining a charging order.

3. Recovering Assets Transferred to the Limited Partnership

A third possible remedy is for the creditor to ignore the charging order remedy and instead try to set aside prior transfers of assets from the debtor to the limited partnership. With these assets no longer in the partnership, they would then be unprotected and subject to creditor seizure.

This is a far more threatening possibility than the dangers from a charging order. Creditors often recover assets fraudulently transferred to the limited partnership. A creditor cannot directly claim limited partnership assets because the assets no longer belong to the debtor-partner, they are owned by the limited partnership under a tenancy-by-partnership. So if the creditor is to obtain the assets, he must first rescind the prior transfer to the partnership as a fraudulent transfer.

Creditors have remedies when assets are fraudulently transferred to a limited partnership (or any other party). For example, if you owe a creditor \$100,000, you might transfer \$70,000 in cash to the limited partnership so that the creditor cannot seize your cash. This could be a fraudulent transfer, and the cash may be recoverable from the partnership (or any other transferee) by the creditor. This result, nevertheless, is far from certain. Much depends upon how you structure

your limited partnership. For instance, if you and your wife each contribute \$70,000 and each obtains in exchange a 50% partnership interest, then the court may agree that the transfer was a fair consideration exchange because you each now own one-half of a limited partnership with assets worth \$140,000. Your interest is equal to your original \$70,000. However, if you and your wife each contributed \$70,000, but you obtain a disproportionately smaller partnership interest, or no interest, then you essentially gave away at least part of your money. That portion would be recoverable by your present creditors.

Many debtors overlook this point. They hurriedly transfer their assets to the limited partnership for a disproportionately small partnership interest because they want little or no interest subject to a creditor's charging order. They overlook the fact that the creditor would pay the larger share of the taxes on partnership profits. This is poor planning, because a present creditor can then successfully argue that the transfer was without fair consideration and thus a fraudulent transfer. Even when the consideration is fair, it does not guarantee that a court won't set aside such a transfer, if made against a present creditor. Many courts find that impairing a present creditor from collection is sufficient to constitute a fraudulent transfer - even when the consideration (the limited partnership interest) has a value corresponding to the value of the transferred asset.

The law on this point varies between states and individual cases. You cannot assume that any transfer to a limited partnership made against a present creditor is safe. The limited partnership certainly provides greater protection than keeping assets titled in your name, but appreciably less protection than would an offshore trust, offshore LLC, or some other foreign structure that keeps the asset beyond the reach of U.S. courts. Liquid assets can be physically transferred offshore beyond the reach of U.S. courts, but we have different problems when your assets must remain U.S.-based - as with real estate. The limited partnership then offers questionable protection. The remedy is to sell or fully encumber the assets (using liens as a debt-shield) and move the proceeds to an offshore trust, or comparably protective structure.

Still, from the debtor's position, the limited partnership shields partnership assets from all but the most determined creditor. A creditor must overcome numerous barriers before he can recover assets. As a practical matter, few creditors pursue a partnership interest or assets conveyed to the partnership unless the claim and the corresponding assets are exceptionally large.