

# ASSET PROTECTION AGAINST CREDITOR AND LITIGATION CLAIMS

Over the past decade, the **Family Limited Partnership** (hereafter “**FLP**”) has become an increasingly popular family strategy for both asset protection and estate planning.

The usual role of the FLP is often to act as a *holding company*, owning certain assets and interests in other entities. The distinguishing features of the FLP are pass-through taxation and a split in management rights between general and limited partnership interests. The combination of these two characteristics makes the FLP a flexible and efficient vehicle for many types of planning.

After setting up the FLP, selected family assets are transferred into it. These may include investment accounts and shares in other business interests. Often it is real property or interest in entities that own real property. When the transfers are complete, Husband and Wife no longer own a direct interest in these assets. Instead, they own, directly or indirectly, a controlling interest in the FLP, and it is the FLP that owns the assets.

**What happens if there is a lawsuit against you?** If a judgment against you were obtained for \$1 million. The plaintiff in the action is now a judgment creditor, and they will try to collect the \$1 million from your personal assets.

The judgment creditor would like to seize your bank accounts and investments in order to collect the amount which he is owed. However, he discovers that you no longer hold title to any of these assets. In fact, since all of these assets have been transferred to the FLP, the only asset held by you is your interest in the FLP.

**Can the creditor reach into the partnership and seize the investments and bank accounts?** The answer is NO. Under the provisions of the Uniform Limited Partnership Act, *a creditor of a partner cannot reach into the partnership and take specific partnership assets*. The creditor has no rights to any property which is held by the partnership. Since title to the assets is in the name of the partnership and it is the Husband or Wife partner rather than the partnership which is liable for the debt, partnership assets may not be taken to satisfy the judgment.

***No creditor of a partner shall have any right to obtain possession or otherwise exercise legal or equitable remedies with respect to the property of the limited partnership.***

It is important to note however that a **charging order** or a **foreclosure of a partner’s interest** in the partnership may be an equally powerful remedy of a creditor. A charging order against your partnership interest means that the general partner is directed to pay

over to the judgment creditor any distributions from the partnership which would otherwise go to the debtor partner, until the judgment is paid in full.

Under the circumstances in which a creditor has obtained a charging order, the partnership would not make any distributions to the debtor partner. This arrangement would be provided for in the partnership agreement and is permissible under partnership law. If the partnership does not make any distributions, the judgment creditor will not receive any payments. The partnership simply retains all of its funds and continues to invest and reinvest its cash without making any distributions.

The result of this technique is that family assets have been successfully protected from the judgment against you. Had the FLP arrangement not been used and had you kept all of your assets in their own names or your Family Trust, the judgment creditor would have seized everything. **Instead, through the use of this technique, all of these assets were protected.**

Use of a limited liability entity as general partner can increase the protection here and the FLP is a valuable tool for asset protection. It merely requires that the proper steps be taken to ensure that ownership of the FLP has been correctly established from the beginning so that neither a charging order nor a foreclosure can be applied and the goal of asset protection will be accomplished.

When real property is transferred into the FLP there is a major advantage of using an FLP to save estate taxes since the assets can be heavily discounted being a minority ownership in a non-liquid asset, and typically the value of the assets, when gifted upon your death is discounted by twenty, thirty or even forty percent.

Since the partnership is a "pass through" entity, there is no potential for income tax on it. Unlike corporations and irrevocable trusts, a partnership is not a taxpaying entity. A partnership files an annual informational tax return setting forth its income and expenses, but it does not pay tax on its net income. Instead, each partner's proportionate share of income or loss is passed through from the partnership to the individual. Each partner claims his or her share of deductions or reports his share of income on his own tax return.

The savings can be substantial and if estate and income tax rise as all predict. It is far more likely that estate tax will increase over the next few years given the economic plight of the Federal government. Therefore, you simply have to assume that if you wish to minimize estate tax and protect your assets from creditors and litigation claims you will have to engage in some advance planning.