Asset Protection for Physicians and High-Risk Business Owners

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CHAPTER FIVE

Asset Protection and Estate Planning with a Family Limited Partnership

Over the past five years, the Family Limited Partnership (FLP) has risen from obscurity, as a little known tax loophole, into the preeminent vehicle for asset protection and estate planning. A recent article in *Forbes* extolling the benefits of the FLP—headlined "Cut Your Estate Taxes in Half"—claimed that individuals were successfully using this technique to discount the value of their estate by up to 90 percent.

In this chapter, we will discuss the features of the Family Limited Partnership which provide remarkable advantages and planning opportunities. By itself, or in combination with other techniques, the FLP can be used to create a powerful strategy for asset protection and for realizing estate tax and income tax benefits. We will start with the background on this technique.

Different Types of Partnerships

General Partnerships

A partnership is formed when two or more persons agree to carry on a business together. This agreement can be written or oral. A *general partnership* is formed when two or more people intend to work together to carry on a business activity. No local or state filings are required to create this type of partnership. This is different than a corporation, which does not come into existence until Articles of Incorporation have been filed with the Secretary of State.

The distinguishing feature of a partnership is the *unlimited liability* of the partners. Each partner is personally liable for all of the debts of the partnership. That includes any debts incurred by any of the other partners on behalf of the partnership. Any one partner is able to bind the partnership by entering into a contract on behalf of the partnership. If Jackson and Wilson are partners, and Wilson signs a contract on behalf of the partnership, Jackson will be personally liable for the full amount. This is true regardless of whether Jackson authorized the contract or whether he even knew of its existence. This feature of unlimited liability contrasts with the limited liability of the owners of a corporation. As discussed previously, when a contract is entered into on behalf of a corporation, the owners are not personally liable for its performance.

Because each of the partners has unlimited personal liability, a general partnership is the single most dangerous form for conducting one's business. Not only is a partner liable for contracts entered into by other partners, each partner is also liable for the other partner's negligence. When two or more physicians or other professionals practice together as a partnership, each partner is liable for the negligence or malpractice of any other partner.

In addition, each partner is personally liable for the *entire* amount of any partnership obligation. For example, Dr. Smith may be one of ten partners in a medical partnership, but he is not responsible for only 10 percent of partnership obligations. He is responsible for 100 percent—even though he owns only a 10 percent interest. If Dr. Smith's other partners are unable to pay their respective shares, he must pay the entire amount.

Limited Partnerships

Obviously, the unlimited liability feature of general partnerships is a serious impediment to conducting business using a partnership format. To mitigate the harsh impact of these rules, every state has enacted legislation allowing the formation of a type of partnership known as a *limited partnership*.

A limited partnership consists of one or more *general partners* and one or more *limited partners*. The same person can be both a general partner and a limited partner, as long as there are at least two legal persons who are partners in the partnership. The general partner is responsible for the management of the affairs of the partnership, and he has unlimited personal liability for all debts and obligations.

Limited partners have no personal liability. The limited partner stands to lose only the amount which he has contributed and any amounts which he has obligated himself to contribute under the terms of the partnership agreement. Limited partnerships are often used as investment vehicles for large projects requiring a considerable amount of cash. Individual limited partners contributing money to a venture, but not having management powers, will not have any personal liability for the debts of the business.

In exchange for this protection against personal liability, a limited partner may not actively participate in management. However, it is permissible for a limited partner to have a vote on certain matters, just as a shareholder has a right to vote on some corporate matters. A typical limited partnership agreement may provide that a majority vote of the limited partners is necessary for the sale of assets or to remove a general partner. The partnership agreement determines whether the limited partners can vote on these matters.

If a limited partner assumes an active role in management, that partner may lose his limited liability protection and may be treated as a general partner. For instance, if a limited partner negotiates a contract with a third party on behalf of the partnership, the limited partner may have liability as a general partner. For this reason, a limited partner's activities must be carefully circumscribed.

Tax Treatment of Partnerships

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 doesn't 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 share of deductions or reports his share of income on his own tax return.

This avoids the potential for double taxation that is always present in a C Corporation. Typically, when a business is expected to show a net loss rather than a gain, the partnership format is used so that the losses can be used by the partners. Limited partnerships have always been used for real estate and tax shelter investments in order to pass the tax deductions through to the individual investors. These losses are then used by the partner to offset other income he might have. Although the Tax Reform Act of 1986 now limits the ability to immediately deduct losses from "passive activities" to offset wages or investment income, the partnership format may still be desirable if the circumstances of the individual partner are such that he is able to take advantage of these losses.

The rules regarding the taxation of partnership activities are lengthy and cumbersome. As a general rule, however, transfers of property into and out of a partnership will not ordinarily produce any tax consequences.

Lawsuit Protection

The Family Limited Partnership is an outstanding device for providing lawsuit protection for family wealth. When used as part of a properly designed overall strategy, an unsurpassed level of asset protection can be accomplished.

Under the typical arrangement, the FLP is set up so that Husband and Wife are each general partners. As such, they may own only a 1 or 2 percent interest in the partnership. The remaining interests are in the form of limited partnership interests. These interests will be held, directly or indirectly, by Husband, Wife, or other family members, depending upon a variety of factors which will be discussed.

After setting up the FLP, all family assets are transferred into it, including investments and business interests. When the transfers are complete, Husband and Wife no longer own a direct interest in these assets. Instead, they own a controlling interest in the FLP, and it is the FLP which owns the assets. As general partners, they have complete management and control over the affairs of the partnership and can buy or sell any assets they wish. They have the right to retain in the partnership proceeds from the sale of any partnership assets, or they can distribute these proceeds out to the partners.

Creditor Cannot Reach Assets

Now, let’s see what happens if there is a lawsuit against either Husband or Wife. Assume that Husband is a physician and that there is a malpractice judgment against him for $1 million. The plaintiff in the action is now a judgment creditor, and he will try to collect the $1 million from Husband.

The judgment creditor would like to seize Husband’s bank accounts and investments in order to collect the amount which he is owed. However, he discovers that Husband no longer holds title to any of these assets. In fact, since all of these assets have been transferred to the FLP, the only asset held by Husband is his 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 partner rather than the partnership which is liable for the debt, partnership assets may not be taken to satisfy the judgment.

Charging Order Remedy

If a judgment creditor cannot reach partnership assets, what can he do? Since Husband's only asset is an interest in the FLP, the creditor would apply to the court for a *charging order* against Husband's partnership interest. A charging order means that the general partner is directed to pay over to the judgment creditor any distributions from the partnership which would otherwise go the debtor partner, until the judgment is paid in full. In other words, money which comes out of the partnership to the debtor partner can be seized by the creditor until the amount of the judgment is satisfied. Cash distributions paid to Husband could, therefore, be taken by the creditor. A charging order does *not* give the creditor the right to become a partner in the partnership and does *not* give him any right to interfere in the management or control of partnership affairs. He only receives the right to any actual distributions paid to Husband.

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 Husband. Had the FLP arrangement not been used and had Husband and Wife kept all of their assets in their own names, the judgment creditor would have seized everything. Instead, through the use of this technique, all of these assets were protected.

Reason for This Law

The law prohibiting a creditor from reaching the assets of the partnership has been well established for many years. In fact, these particular provisions of partnership law were first adopted as part of the English Partnership Act of 1890 and were subsequently adopted as part of the Uniform Partnership Act, which has been the basis of the law in the United States since the 1940s.

The reason for these provisions is that they are necessary to accomplish a particular public policy objective. This policy is that the business activities of a partnership should not be disrupted because of non-partnership related debts of one of the partners. Prior to the adoption of these provisions, it was possible for a creditor of a partner to obtain a Writ of Execution ordering the local sheriff to levy directly on the property of the partnership to satisfy the creditor's debt. The local sheriff went to the partnership's place of business, shut down the business, seized all of the assets, and sold them to satisfy the debt. These methods not only destroyed the partnership's business but also caused a significant economic injustice to the non-debtor partner through the forced liquidation of partnership assets. The non-debtor partner didn't do anything wrong. Why should he be forced to suffer?

To avoid precisely these unfair results, the law was formulated so that a creditor with a judgment against a partner—but not against the partnership—cannot execute directly on partnership assets. Instead, the law allows the creditor to obtain a charging order, which affects only the actual distributions made to the debtor partner. The business of the partnership is allowed to continue unhampered, and the economic interest of the non-debtor partner is not impaired.

The protection of partnership assets from the claims of one partner's creditors is deeply entrenched in the foundation of American and English partnership law. Without such protection, the formation of partnerships would be discouraged and legitimate business activities would be impeded. When understood in this light, it is clear that the asset protection features of a Family Limited Partnership are neither a fluke nor a loophole in the law. Rather, these provisions are an integral part of partnership design, and it is unlikely that changes in the law will ever be made which would impair these features.

How to Save Income and Estate Taxes

Income Tax Benefits

If family assets are held in the form of a limited partnership, it will be possible to obtain certain income tax savings in addition to the asset protection benefits. Tax savings can be realized by spreading income from high tax bracket parents to lower tax bracket children and grandchildren who are fourteen years or older. Let's look at an example of how this might work:

One of our clients had taxable income from various investments of approximately $200,000, consisting of interest and dividends from bonds, stocks, and trust deeds that he owned. He was in a 32 percent maximum tax bracket and paid taxes of approximately $64,000 per year on this income. As part of an overall business plan that we established, all of his assets were transferred into a Family Limited Partnership and a total of seven children and grandchildren were brought in as limited partners of the partnership. Under the partnership agreement, the children and grandchildren were taxable on $100,000 of the $200,000 in income generated by the partnership. Each of these children was in a maximum tax bracket of 15 percent, and thus, the total taxes owed on this $100,000 of investment income was reduced from $32,000 to $15,000. This produced a savings of $17,000 in overall family income taxes. Under the partnership agreement it was not required that the $100,000 actually be distributed to the children. In fact, the parents as general partners retained all of this amount except for what was needed to pay the taxes on the children's share of partnership income. The parents thereby reduced their annual income taxes by shifting a substantial amount of income to their children. The tax savings were held as a college fund for the grandchildren.

Estate Tax Benefits

We can also use the Family Limited Partnership as a vehicle for dramatically reducing or eliminating estate taxes. This estate tax reduction can be accomplished because of certain unique attributes of the FLP which are not present in any other business entity. Of primary importance is the ability to shift the value of assets out of your estate without any concomitant loss of control, through a program of gifting limited partnership interests to your children or other family members.

For example, the Smith family owns a business with a current value of $1 million, a rental property with equity of $500,000, and retirement savings in stocks and bonds equal to $1 million. That's a total estate of $2.5 million. Under current law, with a properly designed estate plan, taking maximum advantage of the combined current exemption of $1.3 million, the estate tax on the balance of $1.2 million would be approximately $500,000. Mr. and Mrs. Smith would like to take steps to preserve the family estate for the benefit of their three children, but they do not wish to give up control over their assets during their lifetime.

One solution to the problem involves a properly structured estate plan including an FLP that is established to hold all family assets. Mr. and Mrs. Smith would be the general partners of the FLP. As such they would have complete management and control over their property in the FLP. Initially, they could make a gift of the limited partnership interests to their children in an amount equal in value to the combined maximum estate tax credit (currently $1.3 million). In subsequent years, they could gift limited partnership interests equal to the amount of the annual gift tax exclusion of $20,000 per child ($60,000 per year).

Under this approach, in roughly seventeen years, the Smiths would be able to eliminate potential estate taxes and could preserve $500,000 of family wealth. At the same time that the Smiths are accomplishing this result, they would not relinquish any degree of control or authority over their real estate or their retirement savings.

That's not a bad result, but we can push the advantages a great deal further. According to IRS rulings and court cases, the value of each gift of a limited partnership interest must be *discounted* in order to account for the lack of marketability and the lack of control associated with those interests. For example, if the parents transfer assets with a value of $1 million to an FLP, a gift of a 1 percent limited partnership interest should not be valued at $10,000. Instead, because the interest cannot be readily sold and because the donee has no right to participate in management of the FLP, a reasonable approach to determine value, suggested by many financial advisors, would be to discount the transferred interest to reflect its true value in the market. Discounts in the range of 30 percent are fairly conservative, but some aggressive advisors push this number to the 50 percent range.

Once this discount is taken into consideration, potential tax savings can be accelerated. Using an aggressive 40 percent discount, the value of the limited partnership interests in the Smith FLP would be discounted in value from $2.5 million to $1.5 million. Almost all of this value could be gifted in the first year without exceeding the credit of $1.3 million. The remaining $200,000 in value could be transferred out of their estate in just one or two years. In a relatively painless fashion, the Smiths have eliminated $500,000 of estate taxes while maintaining control over their assets. If a less aggressive discount is chosen, it might take five or six years to completely eliminate the tax instead of one or two years as we just illustrated.

As an added bonus, this approach will also remove future appreciation from the Smiths' estate. In our example, the rental property and the business have a value today of $1.5 million. Increasing in value at a rate of just 7 percent per year, these assets would be worth an *additional* $1.5 million in just ten years. That's another $750,000 in estate taxes that the Smiths have avoided by the use of the FLP strategy. If you own real estate or a business which you believe will increase in value over the years, the FLP provides an excellent planning opportunity to achieve meaningful estate tax savings.

You should note that the FLP, like all tax planning strategies, is likely to be attacked by the IRS if the requisite formalities are not properly followed. Although Congress has rejected attempts by the Administration to eliminate these benefits and the IRS has not been successful in challenging the FLP in court, those who claim highly aggressive discounts or establish the FLP in near death circumstances can anticipate some level of opposition. As a general rule, if you are using the FLP to achieve estate tax savings, make sure that:

1. A credible appraisal is obtained to support the amount of the discount which is claimed.

2. The documents are properly drafted.

3. There is a sound purpose for the plan other than tax avoidance (such as asset protection or privacy).

Creating the Family Limited Partnership

The first step in creating the Family Limited Partnership is the preparation and filing of the Certificate of Limited Partnership with the Secretary of State. The form asks for the name of the limited partnership. This name should be cleared in advance with the Secretary of State's office because the filing will not be accepted if the name is similar to another name already on file. The Certificate of Limited Partnership also asks for the name of a designated Agent for the Service of Process, which is the name and address of a person (or company) who is authorized by the partnership to receive service of process if the partnership is sued for any reason. Any family member residing in the state can be designated as the agent. There are also companies that will, for a modest fee, act as the designated agent for these purposes.

The form also asks for the names and addresses of all general partners of the partnership. The names of the limited partners are not required. Since this document is a matter of public record, the names of the general partners will be publicly available but not the names of the limited partners. Along with the Certificate of Limited Partnership, each state requires a filing fee which is usually about $85–$125.

When the Secretary of State's office receives the properly filled out form, with an acceptable partnership name, the Certificate will be filed. At this point, the partnership will be legally formed. You should request that a certified copy of the Certificate of Limited Partnership be returned to you, and your copy should be stamped with the filing date. It is essential that you have at least one certified copy for opening a bank or brokerage account, or for the purchase or sale of real estate in the name of the partnership.

The Partnership Agreement

Concurrently with the filing of the Certificate of Limited Partnership, a written partnership agreement must be prepared. This is the document that governs the affairs of the partnership. It sets out the purpose of the partnership, the duties of the general partners, matters on which the vote of the limited partners is required, the share of partnership capital and profits to which each partner is entitled, and all other matters affecting the relations between the partners.

When creating a Family Limited Partnership for estate planning and asset protection purposes, the partnership agreement must also contain certain key provisions designed to accomplish your objectives. Taken together, these provisions must ensure that a creditor can never achieve any influence over partnership affairs and that Husband and Wife, as general partners, always maintain absolute control over the assets of the partnership. These provisions are unique and essential to a properly structured Family Limited Partnership.

Funding the Partnership

The next step in the partnership formation process is the funding of the partnership. That means you must now decide which assets to transfer and the best means for doing so.

Dangerous and Safe Assets

In making the decision about funding the partnership, it is important that you understand the distinction between Safe Assets and Dangerous Assets.

Safe Assets are those which do not, by themselves, produce a high degree of lawsuit risk. For instance, if you own investment securities such as stocks, bonds, or mutual funds, it is unlikely that these assets will cause you to be sued. Mere ownership of investment assets, without some active involvement in the underlying business, would probably not cause a significant degree of lawsuit exposure.

Dangerous Assets, on the other hand, are those which, by their nature, create a substantial risk of liability. These are generally active business type assets, rental real estate, or motor vehicle ownership, any of which may cause you to be sued.

The reason for the distinction between Safe Assets and Dangerous Assets is that you do not wish to have the FLP incur liability because of its ownership of a Dangerous Asset. If the partnership does incur liability, it will be the target of a lawsuit and all of the assets in that partnership will be subject to the claims of the judgment creditor. This is exactly the situation you are trying to avoid. *Dangerous Assets must either be left outside of the partnership or must be placed in one or more separate entities.* Dangerous Assets must be isolated from each other and from Safe Assets, in order to avoid contaminating the Safe Assets.

Dangerous Assets

An example of a Dangerous Asset is an apartment building. The liability potential of apartment houses is particularly high. Although liability insurance coverage is usually available, the amount of coverage may not be sufficient. A fire in a densely populated building may cause severe injury or death to many tenants. The potential liability for such a tragedy could easily reach into the millions of dollars, exceeding by far the amount of your insurance coverage.

Apartment owners can also be held responsible for the acts of the resident managers. If the resident manager engages in race or sex discrimination in renting to tenants, or is guilty of sexual harassment, this liability may be imputed to you as the owner of the property. Acts such as these may not be covered under your standard insurance coverage.

If this asset is transferred to the same Family Limited Partnership that holds all of your other assets, that partnership, as the owner of the property, will face a high degree of lawsuit exposure and all of your assets will again be at risk.

Instead, the best approach for a Dangerous Asset such as an apartment building is to transfer that property to its own *separate* entity. Generally the Limited Liability Company is the proper way to hold Dangerous Assets. Since no individual member of an LLC can be sued for an LLC related obligation, the liability associated with the Dangerous Asset can be contained and insulated in the LLC. If a number of Dangerous Assets are owned, each should be placed in a separate entity. Once we formed thirty-two different LLCs for a client, each holding one apartment building. If a disaster occurred, only the LLC which owned that property would be sued. The other properties and family assets were safely insulated and shielded from liability under this arrangement.

Some types of commercial real estate may also constitute Dangerous Assets. Office buildings, hotels, restaurants, nightclubs, or any other building where many people work or gather, all have the potential to produce stratospheric liability in the event of some type of disaster.

A physician client owned a medical office building in his Professional Corporation. His medical practice and the property were both Dangerous Assets and a liability produced by either would jeopardize the other. For example, a problem arising from the building would produce a claim against the equipment, accounts receivable, and cash in the corporation. The office building should have been separated from the medical practice by holding it in a separate LLC. Dangerous Assets must be kept separate from each other asset. We will discuss details about the use and operation of the LLC in the next chapter.

Safe Assets

Safe Assets with a low probability of creating lawsuit liability can be maintained in a single Family Limited Partnership.

Although the family home is a Safe Asset, with liability issues generally covered by insurance, there are a number of tax issues which arise with respect to the transfer of the family home into the Family Limited Partnership. The first problem concerns the availability of the income tax deduction for home mortgage interest. Section 163 of the Internal Revenue Code permits a deduction for "qualified residence interest." A "qualified residence" is defined as the "principal residence" of the taxpayer. The only requirements appear to be that (1) the house is the principal residence of the taxpayer; (2) interest is paid by the taxpayer; and (3) the taxpayer has a beneficial interest in any entity that holds legal title to the property. Based upon the language of the statute, the deduction for mortgage interest would, therefore, not seem to be adversely affected by a transfer into the Family Limited Partnership. However, until the law on this issue has been conclusively decided *you should not risk the consequences of a disallowance of your mortgage interest deduction.*

Similar tax issues concern the ability to avoid up to $500,000 of the gain from the sale of your home. It is likely that a transfer of your residence into the FLP would cause you to lose this tax advantage. For these reasons, we do not recommend using the FLP to hold the family residence.

An alternative is to use a specially designed trust to own the home. All of the tax benefits will be preserved and the highest level of protection can be maintained.

Bank and Brokerage Accounts

These types of accounts do not create any potential liability and can be transferred into the Family Limited Partnership. In order to open these accounts in the name of the partnership, you will present the financial institution with a certified copy of the Certificate of Limited Partnership. The institution will also require the Taxpayer Identification Number issued to the partnership by the Internal Revenue Service.

Interest In Other Entities

The Family Limited Partnership is an excellent vehicle for holding interests in other business entities. The reason that we mention these other business entities is that the Family Limited Partnership must not ever be engaged in any business activities. You do not want the partnership to buy or sell property or goods or to enter into contracts. If the partnership does business, then the partnership can get sued. And if the partnership gets sued and loses, all of the assets that it holds can be lost.

For example, a client of ours entered into a contract to purchase a shopping center. Previously, we had set up a Family Limited Partnership for him. Without our knowledge, the "Buyer" under the purchase contract was the Family Limited Partnership. During the pre-closing escrow period, financing became unavailable and the client failed to complete the deal. The seller sued the partnership for damages for breach of contract and was awarded $600,000 wiping out a substantial portion of our client's assets. The seller sued the partnership because the partnership was the named party to the contract.

This transaction should not have been handled in this manner. The proper way to conduct this type of business activity is through a separate LLC or partnership arrangement. By using the proper planning techniques, potential liability can be significantly reduced and valuable personal assets can be protected from a dangerous lawsuit. Had this arrangement been used, our client would not have lost $600,000. Instead, the buyer and seller would probably have re-negotiated the terms of the purchase in a way that was mutually satisfactory to each side.

This example illustrates the necessity for conducting business activities through an entity other than the Family Limited Partnership so that family assets are not exposed to the risk of liability. The proper role of the Family Limited Partnership in this context is to hold the interests in the business entities that are themselves subject to risk. The FLP can hold these interests, providing asset protection and estate planning advantages in a single integrated package.

Summary

The Family Limited Partnership offers a unique capability to realize a variety of planning goals.

- Assets held in the FLP are effectively shielded from potential claims.
- Income taxes can be shifted to lower bracket family members or entities such as corporations and trusts to take advantage of deferral and savings techniques.
- Estate taxes on accumulated wealth and future appreciation can be minimized or eliminated by gifting discounted interests in the FLP to children or trusts established for their benefit.

The FLP provides a convenient and flexible format as the cornerstone of your overall plan. In the succeeding chapters we will see how Limited Liability Companies and trusts can provide additional opportunities to create asset protection and tax savings strategies.