

FAMILY LIMITED PARTNERSHIPS, TRUSTS, OR LIMITED LIABILITY CORPORATIONS: WHICH SHOULD THE ELDERLY CHOOSE?

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A variety of planning devices are available for the elderly that allow them to save taxes and protect assets. These devices include trusts, family limited partnerships (FLPs), and limited liability companies (LLCs). However, recent court cases have brought into question the effectiveness of FLPs as planning devices. Moreover, LLCs are relatively recent inventions, and their effectiveness may be uncertain. Mr. Baumann investigates the advantages and disadvantages of these planning tools and concludes that FLPs should be avoided by the elderly in favor of trusts and LLCs.

I. Introduction

Elderly clients can use a variety of financial planning devices to meet their needs. Often, the elderly's needs match those of the general population. For example, they, like others, want to save on taxes. They want to pay the IRS the least amount of federal income tax possible. If they decide to give gifts, they want to minimize the transfer taxes involved. The elderly, like others, want to protect their assets from creditors. If they are involved in a business, they may want to shield themselves from the effects of judgments against the business.

On the other hand, the elderly often have unique concerns. Some elderly individuals may face nursing home care and may worry about how their assets will affect their Medicaid eligibility.¹ The eld-

1. Susan Fox Buchanan & James W. Buchanan, III, *Strategies for Clients Residing in Nursing Homes*, EST. PLAN., Jan.-Feb. 1993, at 27, 30-31.

erly also have concerns over the probate process and may want to minimize the cost and publicity of that process.²

A variety of financial planning techniques is available to the elderly client. Recently, family limited partnerships (FLPs) and limited liability corporations (LLCs) have emerged as techniques that the general public uses to protect assets from creditors, save taxes, and maintain control over their affairs.³ The question arises as to whether the elderly should use these new techniques given recent developments in case law, legislation, and the unique concerns of the elderly.

This note evaluates FLPs and LLCs and compares them to traditional trust arrangements. Part II gives a background of FLPs, trusts, and LLCs. Part III evaluates these devices in terms of the concerns of the elderly. Part IV concludes by recommending that the elderly avoid FLPs and use a combination of trusts and LLCs to meet their needs.

II. Background

A. Family Limited Partnerships

Family wealth planning has changed in recent years.⁴ In the last several years, planners emphasized multigenerational tax savings.⁵ However, as a result of the compressed tax rate schedule and judicial and legislative reduction of income tax planning opportunities, the emphasis of planning has shifted to the creditor protection area.⁶ As a result, planners have given family limited partnerships increased attention.⁷ Some commentators argue FLPs not only offer tax savings but protection from judgment creditors as well.⁸

The Revised Uniform Limited Partnership Act (RULPA) defines family limited partnerships along with other limited partnerships.⁹ To form an FLP, a group of at least two people must file a certificate which meets the requirements of RULPA with the jurisdiction's Secre-

2. SIDNEY KESS & BERTIL WESTLIN, CCH ESTATE PLANNING GUIDE 203 (1989).

3. Thomas E. Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer* (pt. 1), 37 S.D. L. REV. 44, 44-45 (1992); Richard A. Oshins, *Family Wealth Protection and Preservation*, TR. & EST., Feb. 1993, at 38, 38.

4. Oshins, *supra* note 3, at 38.

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.* at 40.

9. REV. UNIF. LIMITED PARTNERSHIP ACT §§ 701-702 (1985).

tary of State's office.¹⁰ The FLP usually must contain one or more general partners and one or more limited partners.¹¹ This note uses the RULPA adoption of FLPs, not one particular state's adoption of that standard.

In *Commissioner v. Culbertson*,¹² the U.S. Supreme Court tried to clarify what requirements an organization must meet to be classified as a partnership.¹³ The Court held that it would consider an organization a partnership if, by evaluating all relevant facts, it found the parties, acting in good faith and with a business purpose, intended to join together in the present conduct of business.¹⁴ Relevant facts include the partnership agreement, the conduct of the parties in executing the agreement's provisions, the testimony of disinterested persons, the relationship of the parties, the parties' respective abilities, the parties' capital contributions, the actual control of income and the purposes for which it is used, and any other facts that clarify the parties' true intent.¹⁵ After the Court's decision, Congress further clarified the meaning of the Court's language.¹⁶ Congress required that for an organization to be considered a partnership, the partnership must contain some income-producing activity.¹⁷

The family limited partnership has both general and limited partners.¹⁸ A limited partner contributes assets in exchange for interests in the partnership.¹⁹ These assets can include cash or other property or services.²⁰ The limited partners have the right to look at the partnership books kept at the principal place of business and, at all times, to inspect these books.²¹ They also can demand a full and true accounting of the partnership and have the right to receive a share of the profits or other compensation.²²

10. *Id.* § 201.

11. *Id.* § 101(7).

12. 337 U.S. 733 (1949).

13. *Id.* at 741-45.

14. *Id.* at 742.

15. *Id.*

16. I.R.C. § 704(e) (1988).

17. *Id.*; see also *Tower v. Commissioner*, 327 U.S. 280, 287 (1946).

18. REV. UNIF. LIMITED PARTNERSHIP ACT §§ 301-305, 401-405 (1985).

19. Barry S. Engel & Ronald L. Rudman, *Family Limited Partnerships: New Meaning for "Limited,"* TR. & EST., July 1993, at 46.

20. REV. UNIF. LIMITED PARTNERSHIP ACT § 101 (1985).

21. *Id.* § 105.

22. *Id.* §§ 305, 503.

The general partner or partners can do anything a partner in a partnership without limited partners can do.²³ The general partners of a limited partnership, however, become personally liable for any debts of the partnership.²⁴ Full liability distinguishes general partners from limited partners and from officers of corporations who are not liable personally for the debts of the partnership or corporation.²⁵ Thus, one reason to prefer a limited partnership, such as an FLP, is that it provides for the limited liability of its members.

The partnership agreement determines the allocation of profits and losses among the partners.²⁶ Distributions of cash and other assets of a limited partnership are determined by the partnership agreement.²⁷ If the partnership agreement does not specify how the distributions will be made, then the distributions are made based upon the value of the principal invested.²⁸ The partnership agreement also determines the timing of the distributions.²⁹ Often, the agreement gives complete discretion to the general partner or partners in making the distributions.³⁰

Both the elderly and nonelderly can create family limited partnerships.³¹ For example, parents may own an interest in a farm or other business that they wish to keep in the family.³² Parents fear that if they find themselves in financial trouble in the future, their creditors or bankruptcy trustees might seize the property.³³ They convey the property into a family limited partnership, with the parents and trusts (for the children) as limited partners, and a friendly family member as the general partner.³⁴

As another example, elderly individuals, in good health, nearing retirement, can create an FLP to protect their home and business. The elderly person conveys the property into a limited partnership with

23. *Id.* § 403.

24. *Id.* One advantage of general partnerships is lack of constraints as to what partners can do.

25. Compare *id.* § 403 with *id.* § 303 (comparing general powers and liabilities of general partners to liabilities of limited partners).

26. *Id.* § 503.

27. *Id.* § 504.

28. *Id.*

29. *Id.*

30. Oshins, *supra* note 3, at 43.

31. See Kathryn G. Henkel, *How Family Limited Partnerships Can Protect Assets*, EST. PLAN., Jan.-Feb. 1993, at 3, 3.

32. *Id.*

33. *Id.*

34. *Id.*

the elderly person as a limited partner and a friendly relative as the general partner. The general partner determines when and if distributions are made.³⁵

B. Trusts

Trusts exist in many forms. This note will discuss certain types of trusts that the elderly might use. The creator or settlor of a trust puts property in a trust for the benefit of a beneficiary or beneficiaries.³⁶ A trustee holds legal title to the property, manages the property, and makes distributions of the trust income and assets as directed by the trust agreement.³⁷ Thus, the trustee manages the trust for the benefit of someone else.³⁸

A trust can have many features. These include revocability, provisions for special needs, and tax and funding features. Moreover, a skilled planner can combine these features to create unique arrangements.

The elderly often debate whether to make the trust arrangement revocable.³⁹ In the revocable trust arrangement, the settlor reserves the power to revoke the trust.⁴⁰ Thus, if settlors become dissatisfied with the performance of the trustee or the beneficiaries, they can "take back" the property by revoking the trust.⁴¹ Upon death of the settlor, the assets remaining in the trust pass to the designated remainder beneficiaries.⁴² On the other hand, in an irrevocable trust, the settlor cannot revoke the trust and thus "loses" the property forever.⁴³ For this steep price, however, the trust offers tax and probate advantages.⁴⁴

Elderly individuals might want to put some cash in a revocable trust for the benefit of their very young grandchildren. The trustee might commence distributions when the beneficiaries reach age eighteen. Elderly individuals might choose this type of trust because they want to reserve the power to revoke. Perhaps the grandchildren will enter into a life of crime or become unworthy in other respects to re-

35. Oshins, *supra* note 3, at 43.

36. KESS & WESTLIN, *supra* note 2, at 173.

37. *Id.*

38. *Id.*

39. *Id.* at 197.

40. *Id.* at 202-03.

41. *Id.*

42. *Id.*

43. *Id.* at 198.

44. *Id.*

ceive the money when they reach age eighteen. However, if the facts are changed, the elderly person might use an irrevocable trust. For example, the grandchildren might be already grown and be model citizens. Thus, some elderly individuals may not be concerned about "losing" their money, so the planner might use an irrevocable trust as the best arrangement.

A planner might want to design a trust to surmount the Medicaid qualifying trust (MQT) limitation.⁴⁵ The government might "deem" the assets of the trust as available to a Medicaid applicant.⁴⁶ As such, Medicaid electability rules require that a Medicaid applicant use these assets before he or she can receive Medicaid.⁴⁷ Thus, if an elderly person has any kind of trust where the assets are deemed available to the elderly person or spouse, the government might disqualify the elderly person from receiving Medicaid.⁴⁸ Recent federal legislation further limits Medicaid eligibility by deeming more assets as available to the applicant.⁴⁹

To surmount the MQT problem, an elderly person contemplating nursing home care might consider a special-needs trust, a discretionary trust, or a nongrantor trust.⁵⁰ A planner specifically tailors each of these arrangements to get around the MQT limitation.⁵¹

In a special-needs trust, the trust agreement provides that the elderly person cannot use the income from the trust or the trust assets

45. Sanford J. Schlesinger et al., *Medicaid Planning Ideas: What Works and What Doesn't*, EST. PLAN., Nov.-Dec. 1993, at 331-39. The term MQT is really a misnomer because such trusts usually *disqualify* an elderly applicant from receiving public support. *Id.* at 332.

46. Michael Gilfix, *Special Trusts for Asset Preservation and Planning*, TR. & EST., Feb. 1993, at 62, 64.

47. Schlesinger et al., *supra* note 45, at 331.

48. *Id.* at 332. Generally, MQT rules do not apply where the trustee has no discretion to make distributions, where there is undue hardship, or with inter vivos trusts created by third persons and testamentary trusts. *Id.* at 332. The note discusses all of the exceptions except undue hardship. For an example of a statutory hardship, see *id.* (citing 10 COLO. CODE REGS. § 8.11054(e) (1992)).

49. 42 U.S.C. § 1396p(c)(1) (1994). This act limits Medicaid eligibility by extending the look-back period from 30 to 36 months, extending the look-back period for transfer of assets from 30 to 60 months, and extending the maximum Medicaid ineligibility period to a potentially unlimited period. *Id.* The Act also offers regulations for defining hardship and provides for states to set up procedures if application of rules causes hardship. *Id.* Finally, the Act extends the definition of resource transfers, applies Medicaid rules to all types of trusts, includes all assets of a trust, and defines *assets* to include all income and resources for the individual and spouse. *Id.* § 1396p(d)-(e).

50. Schlesinger et al., *supra* note 45, at 334-39.

51. *Id.*

for personal medical care.⁵² These terms also specify that the assets and income from the trust cannot be used to pay for anything that normally would be covered by Medicaid or any other public assistance program.⁵³ The trust agreement specifies that trust income and assets can only be used to pay for "special needs."⁵⁴ The trust agreement defines *special needs* as services not provided by public assistance programs.⁵⁵ The beneficiary is not given the authority to revoke the trust.⁵⁶ Further, the beneficiary cannot direct the trustee to distribute trust funds for the beneficiary's food, housing, or clothing.⁵⁷ Thus, the beneficiary will not use the trust assets and Medicaid should not deem the assets available to the Medicaid applicant.⁵⁸

A purely discretionary trust is one in which the trustee has unlimited discretion over distributions to or on behalf of the beneficiary.⁵⁹ Because the beneficiary of a discretionary trust is not entitled to the assets legally, he or she has no property interest in the trust reachable by creditors, and this type of trust surmounts the MQT limitation.⁶⁰ A planner can also use an inter vivos trust set up by a third party as another way to surmount the MQT limitation.⁶¹ "Assets of a third party trust are an available resource only to the extent that [the grantor intended them] to be used for the [Medicaid] applicant's support."⁶²

Other trusts can also be used by the elderly. For example, a standby trust stands in readiness to manage the assets of settlors when they can no longer manage the assets themselves.⁶³ It may provide for a takeover upon the settlor's medical or physical incapacity or when the settlor leaves on a vacation or otherwise becomes unable to

52. Gilfix, *supra* note 46, at 63.

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

59. Schlesinger et al., *supra* note 45, at 335. The courts in a few states have held that a beneficiary of a purely discretionary trust *has* some property interest because a trustee has an obligation to exercise discretion consistent with any purpose stated in the trust agreement. *Id.* at 336. See generally *In re Lackmann*, 320 P.2d 186 (Cal. Ct. App. 1958); *In re Dodge*, 281 N.W.2d 447 (Iowa 1979); *Connstaza v. Verona*, 137 A.2d 614 (N.J. Super. Ct. Ch. Div. 1958); *Ohio Bureau of Support v. Kreitzer*, 243 N.E.2d 83 (Ohio 1968).

60. Schlesinger et al., *supra* note 45, at 336.

61. *Id.* at 334.

62. *Id.*

63. KESS & WESTLIN, *supra* note 2, at 207.

manage his or her affairs.⁶⁴ A planner does not use a standby trust to save taxes, although it can be structured to do so.⁶⁵ The settlor usually makes the trust revocable to begin with, but he or she may add the condition that the trust becomes irrevocable upon the settlor's permanent disability.⁶⁶

A settlor also can create a trust by will.⁶⁷ These trusts are known as testamentary trusts.⁶⁸ Commentators describe them as appropriate for individuals who are unable or unwilling to part with certain property while they are alive and who want the control that a trust can give them for what they believe to be the best interests of their beneficiaries in the short or long run.⁶⁹ In contrast to a living trust (created and in operation during the settlor's life), the testamentary trust takes effect on the settlor's death.⁷⁰ Because the trust is in a will, it must meet probate formalities.⁷¹

An elderly person uses a grantor retained income trust (GRIT) to pay a trust income or give use of the trust principal for a term of years, with the remainder passing to family members.⁷² The GRIT trust does not save income taxes but does produce estate tax savings.⁷³

A planner designs a GRIT to take advantage of I.R.C. section 2036(c)(6) and to take advantage of the two types of GRITs.⁷⁴ A settlor funds an enterprise GRIT with assets in which the grantor has a substantial interest.⁷⁵ The other type, exempt GRITs, holds assets in which the grantor does not have a substantial interest.⁷⁶ With a GRIT, if the grantor lives out the terms of the trust, the grantor removes the property from the estate.⁷⁷ Thus, the GRIT trust arrangement can result in substantial estate tax savings.⁷⁸

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.* at 210.

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.*

In a pour-over trust, settlors "pour" assets into the trust from another source or sources.⁷⁹ The other assets may come from settlors' wills or from a source completely outside their testamentary estates.⁸⁰ These other assets transferred include assets from employee benefit plans, Keogh plans, IRAs, or insurance proceeds.⁸¹ Pour-overs represent a fairly recent development in the law.⁸² Almost all states now allow pour-over trusts, but some statutes may not resolve all of the related issues.⁸³

A settlor can make a pour-over trust either revocable or irrevocable with all the advantages and disadvantages of both.⁸⁴ If they create revocable trusts, settlors can make changes and adjustments as circumstances change.⁸⁵ If they make the trust irrevocable, then change is barred, and a settlor will want to build enough flexibility into the trust so the trustee can make changes.⁸⁶

The pour-over trust is used when there are multiple beneficiaries and multiple assets.⁸⁷ It permits a convenient consolidation of these assets; the coordination makes use of the assets in the manner closest to the way the settlor made use of them.⁸⁸

C. The Limited Liability Corporation

In 1977, a new type of business organization appeared that combines the organizational and tax attributes of corporations and partnerships: the limited liability corporation (LLC).⁸⁹ Wyoming, in 1977, became the first state to adopt LLC legislation.⁹⁰ Five years later, Florida enacted the Florida Limited Liability Corporation Act.⁹¹ Cur-

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.* Pour-overs became popular during the past two decades. *Id.*

83. *Id.* at 207. These issues include assets allowed in the trust and formation issues.

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. Geu, *supra* note 3, at 45. Another type of corporation, the subchapter S corporation, has been available for decades for family-owned businesses. See Gene Meyer, *A Good Defense*, CHI. TRIB., Jan. 25, 1994, at D1, D11. However, S corporations have restrictions on who can be in them while LLCs do not. *Id.* at D11. This note does not cover S corporations.

90. Geu, *supra* note 3, at 45.

91. *Id.*

rently, twenty-eight states provide for LLC creation by statute.⁹² Some commentators expect all states to adopt LLC statutes by the mid-1990s.⁹³

In the 1980s, the uncertainty over whether the IRS would classify the LLC as a partnership or a corporation for tax purposes stifled further LLC legislation.⁹⁴ But, finally, in 1988, the IRS determined it would classify the LLC as a partnership for income tax purposes.⁹⁵ Although at that time whether states not recognizing LLCs would recognize the limited liability of members of LLCs organized in other states was uncertain, many states in the late 1980s quickly followed the lead of Wyoming and Florida and adopted LLC statutes.⁹⁶

One commentator classifies LLC statutes as either *bulletproof* or *flexible*.⁹⁷ Bulletproof statutes usually have mandatory provisions concerning limited liability, transferability of assets, centralized management, and continuity of life.⁹⁸ These statutes classify LLCs as

92. These statutes include: ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (West Supp. 1994); ARK. CODE ANN. §§ 4-32-101 to -1316 (Michie Supp. 1993); COLO. REV. STAT. ANN. §§ 7-80-101 to -1101 (West Supp. 1994); DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (Michie 1993 & Supp. 1994); FLA. STAT. ANN. §§ 608.401-.514 (West Supp. 1995); GA. CODE ANN. § 14-9-206 (1993); IDAHO CODE §§ 53-601 to -672 (Michie 1994); 805 ILL. COMP. STAT. § 180/1-1 to 60-1 (Michie Supp. 1994); IND. CODE ANN. §§ 23-18-1-1 to -18-13-1 (West 1994 & Supp. 1994); IOWA CODE ANN. § 490A.100-.1601 (West Supp. 1994); KAN. STAT. ANN. §§ 17-7601 to -7652 (Supp. 1993); LA. REV. STAT. ANN. §§ 12:1301-1369 (West 1994); MD. CORPS. & ASS'NS CODE ANN. §§ 4A-101 to -1103 (Michie 1993 & Supp. 1994); MICH. COMP. LAWS ANN. §§ 450.4101-.5200 (West Supp. 1994); MINN. STAT. ANN. §§ 322B.01-.960 (West Supp. 1995); MO. ANN. STAT. §§ 47.010-.735 (West Supp. 1994); MONT. CODE ANN. §§ 35-8-101 to -1307 (1993); NEB. REV. STAT. §§ 67-233 to -296 (1990 & Supp. 1994); NEV. REV. STAT. §§ 86.011-.571 (Michie 1994); N.M. STAT. ANN. §§ 53-19-1 to -74 (Michie 1993); N.D. CENT. CODE §§ 10-32-01 to -155 (Michie Supp. 1993); OKLA. STAT. ANN. tit. 18, §§ 2000-2060 (West Supp. 1995); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to -59 (Michie Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 1528n (West 1992); UTAH CODE ANN. §§ 48-2b-101 to -158 (Michie 1994 & Supp. 1994); VA. CODE ANN. §§ 13.1-1000 to -1073 (Michie 1993 & Supp. 1994); W. VA. CODE §§ 31-1A-1 to -69 (Michie Supp. 1994); WYO. STAT. §§ 17-15-102 to -143 (Michie Supp. 1994).

93. Brian L. Schorr, *Limited Liability Companies: Features and Uses*, in FORMING AND USING LIMITED LIABILITY COMPANIES 193, at 191, 193 (P.L.I. Corp. Law & Practice Course Handbook Series No. 805, 1993).

94. Geu, *supra* note 3, at 94. A major consideration for planning purposes are the tax consequences of a business organization. A taxpayer usually prefers the IRS to classify an organization as a partnership, rather than a corporation, because a corporation is taxed twice: the government taxes the corporate profits directly and the shareholder also pays taxes on the dividend. On the other hand, partners pay only one tax on their share of the partnership profits.

95. John C. Ale, *An Introduction to Limited Liability Companies*, PRAC. LAW., Dec. 1992, at 35, 37; see Rev. Rul. 88-76, 1988-2 C.B. 360.

96. Ale, *supra* note 95, at 37.

97. Schorr, *supra* note 93, at 191.

98. *Id.*

partnerships for tax purposes.⁹⁹ Thus, the planner has little flexibility concerning some provisions.¹⁰⁰ The commentator classifies the LLC statutes of other states as flexible because they provide for broad flexibility in structuring the LLC concerning the transferability of assets, centralized management, and continuity of life.¹⁰¹ Both flexible and bulletproof statutes often have default provisions.¹⁰²

All LLC statutes provide for the limited liability of the members of the LLC.¹⁰³ However, the duration of the LLC varies among the states.¹⁰⁴ For example, some states that have adopted LLC statutes provide for a term of thirty years.¹⁰⁵ Other states do not establish a maximum period.¹⁰⁶

All LLC statutes require filing articles of organization before any LLC may be formed.¹⁰⁷ The contents of the articles of organization vary among jurisdictions.¹⁰⁸ The statutes require information providing the total amount of investment and the names of the members of the corporation.¹⁰⁹

The basic management structure of LLCs is similar to both limited partnerships and corporations.¹¹⁰ Articles of organization and operating agreements usually govern LLC management activities.¹¹¹ Absent contrary provisions, management power of LLCs vests in the members, similar to that of partnerships.¹¹² However, some states significantly depart from the management structure of the partnership by saying that the power of the members is determined in proportion to their capital investment in the LLC.¹¹³ The LLC statutes of other

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.* Default provisions about transferability of interests, centralized management, and continuity of life govern unless the owners change them.

103. Geu, *supra* note 3, at 50.

104. *Id.* at 54. Some states have 30-year limits; others are indefinite.

105. *Id.*; see COLO. REV. STAT. § 7-80-204(1)(b) (1992); FLA. STAT. ANN. § 608.407(1)(b) (West 1993); NEV. REV. STAT. § 86.161 (Michie 1994); TEX. REV. CIV. STAT. ANN. art. 1528n (West 1992); WYO. STAT. § 17-15-107 (Michie Supp. 1994).

106. Geu, *supra* note 3, at 54; see KAN. STAT. ANN. § 17-7607(2) (Supp. 1993); UTAH CODE ANN. § 48-2b-116(1)(b) (Michie 1992); VA. CODE ANN. § 13.1-1011 (Michie 1993).

107. Geu, *supra* note 3, at 56.

108. *Id.*

109. *Id.*

110. *Id.* at 63.

111. *Id.*

112. *Id.*

113. *Id.*; see KAN. STAT. ANN. § 17-7612 (1992).

states do not vest power in the members, but in managers.¹¹⁴ These states provide for a detailed management structure similar to a board of directors.¹¹⁵ The existence of managers often complicates the statutory scheme because it bifurcates the management functions from the ownership functions of the LLC.¹¹⁶ Thus, the most recent LLC statutes which provide for managers often enumerate the duties of the managers.¹¹⁷ For example, these statutes emphasize that the managers of the LLC owe fiduciary duties to the other members of the LLC.¹¹⁸ Several states enumerate these duties in their LLC statutes.¹¹⁹ Like members of partnerships, members of the LLC enjoy "flow through" federal income taxation.¹²⁰ However, unlike a partnership, the members have no liability beyond their contributions.¹²¹ Most LLC statutes require that the LLC have at least two members.¹²²

LLCs appeared on the legal scene recently and some issues remain unsettled.¹²³ For example, no case law exists that speaks to the

114. Geu, *supra* note 3, at 64; see COLO. REV. STAT. § 7-80-403 (West Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 2.13 (West 1992).

115. Geu, *supra* note 3, at 64.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.* For example, the Virginia law provides that:

A. A manager shall discharge his or its duties as a manager in accordance with the manager's good faith business judgment of the best interests of the limited liability company.

B. Unless a manager has knowledge or information concerning the matter in question that makes reliance unwarranted, a manager is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, if prepared or presented by:

1. One or more managers or employees of the limited liability company whom the manager believes, in good faith, to be reliable and competent in the matters presented;

2. Legal counsel, public accountants, or other persons as to matters the manager believes, in good faith, are within the person's professional or expert competence; or

3. A committee of the managers of which the manager is not a member if the manager believes, in good faith, that the committee merits confidence.

C. A person alleging a violation of this section has the burden of proving the violation.

VA. CODE ANN. § 13.1-1024.1 (Michie 1993).

120. Geu, *supra* note 3, at 45.

121. *Id.*

122. *Id.* at 57-58.

123. *Id.* at 53.

issue of whether a state that does not recognize LLCs would recognize the limited liability of members of an LLC.¹²⁴

III. Analysis of How the FLP, Trust, and LLC Serve the Needs of the Elderly

A. Overall Method

This note evaluates FLPs, trusts, and LLCs on the basis of several factors mentioned in the previous section. First, the note evaluates these arrangements on the basis of asset protection. Elderly persons may want to keep their assets away from creditors. They may want to make family residences or businesses as “creditor proof” as possible. Also, elderly persons may operate businesses that subject them to a greater than normal amount of risk of suffering large tort judgments. If someone sues an elderly person because of his or her business relationship, the elderly person will want to reduce his or her liability to the least amount possible.

Next, the elderly, like all others, want to save on taxes, whether federal income, estate, or transfer taxes. In addition to collecting income taxes, the government imposes estate taxes on property transferred at death.¹²⁵ The government levies the estate tax on the grantor’s estate and not on the heir receiving the property.¹²⁶ The government also collects a transfer tax. This is a tax upon the passing of title to property or any other valuable interest out of or from the estate of a decedent by inheritance, devise, or bequest.¹²⁷ Recently, the government broadened the transfer tax at the federal level and included transfers not previously covered. For example, under the 1986 Tax Reform Act, a generation-skipping transfer tax (GSTT) was imposed on transfers under trusts (or similar arrangements) having beneficiaries in more than one generation below that of the transferor.¹²⁸ Before Congress enacted the GSTT, a creator of a trust put money in the trust and the government did not impose a tax on the death of a remote beneficiary.¹²⁹ However, the Tax Reform Act of 1986 imposed a flat rate tax on the beneficiary’s death.¹³⁰

124. *Id.*

125. KESS & WESTLIN, *supra* note 2, at 3-4.

126. *Id.*

127. *Id.* at 81.

128. *Id.* at 631-33.

129. *Id.* at 631.

130. *Id.* at 631-32.

This note also evaluates FLPs, trusts, and LLCs in terms of the control they provide to the creator of the arrangement. Often, the elderly worry about how much control they will have over the management of property they transfer into FLP, trust, or LLC arrangements. Frequently, elderly individuals want to maintain control and reserve the possibility of changing the relationship based on circumstances which occur after the arrangement is created. For example, the elderly person's relationship with family members may change over time. They may view beneficiaries as deserving of their property at one point, but later may want to revoke an arrangement if the beneficiaries become undeserving of their property. The amount of control and the flexibility to change any financial planning device are important factors in the selection of these devices.

Also, the elderly have concerns unique to them. These include Medicaid eligibility questions as well as probate questions. In order to qualify for Medicaid, elderly persons have to use up most of their assets.¹³¹ The question arises as to whether an FLP, trust, or LLC arrangement can circumvent this problem.

Finally, probate often costs a great deal of money and makes the financial secrets of the deceased public knowledge. The probate process often does not move quickly and prolongs the suffering of family members. Thus, the elderly often want to avoid the process.

B. Family Limited Partnerships

1. ASSET PROTECTION

The Revised Uniform Limited Partnership Act discusses the liability of partners to creditors when assets are put into any kind of limited partnership.¹³² Creditors usually obtain a charging order from a court as the remedy.¹³³ Thus, the creditor can theoretically receive only distributions from the partnership and not the partnership interest itself.¹³⁴ Because the elderly person controls the general partner and this general partner determines the amount and timing of the distributions from the partnership, a judgment creditor receives an asset of relatively little value.¹³⁵ The judgment creditor does not substitute for the elderly person as a limited partner and thus has no vote or

131. Buchanan & Buchanan, *supra* note 1, at 31.

132. REV. UNIF. LIMITED PARTNERSHIP ACT § 703 (1985).

133. Oshins, *supra* note 3, at 43.

134. *Id.*

135. *Id.*

management voice in the family limited partnership.¹³⁶ Also, the creditor is not entitled to any information about the limited partnership's transactions and is not entitled to look at the books of the partnership.¹³⁷ Finally, the general partner will continue to control the partnership assets.¹³⁸

Another deterrent for a creditor is that, for income tax purposes, obtaining a charging order results in the IRS treating the creditor as the owner of the interest for tax purposes.¹³⁹ Thus, judgment creditors must pay tax on the income earned on that portion of the partnership even though they do not receive the income earned by that part of the partnership.¹⁴⁰ In many situations, the holder of a charging order on a family limited partnership has an asset of negative value.¹⁴¹ Some commentators describe the effect of creating an FLP, even if created by freely marketable assets, as the conversion of desirable assets into assets that are unattractive and undesirable.¹⁴²

However, these positive asset protection characteristics of FLPs have been jeopardized by two recent decisions by California courts.¹⁴³ In *Centurion Corp. v. Crocker National Bank*,¹⁴⁴ the bank obtained a judgment of \$1,431,688 against Jon Perroton.¹⁴⁵ Perroton had an interest in a limited partnership known as California Self Storage.¹⁴⁶ After the judgment, the bank obtained an order charging Perroton's interest with the unsatisfied judgment plus interest.¹⁴⁷ As of November 1985, the bank had received no money as a result of the charging order.¹⁴⁸ On November 26, 1985, the bank moved for a sale of Perroton's interest in the limited partnership.¹⁴⁹ After a hearing, a court ordered that the interest in the limited partnership be sold.¹⁵⁰ Later, pursuant to California Code of Civil Procedure section 473, Perroton moved to

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.*

141. *Id.* at 44.

142. *Id.*

143. Engel & Rudman, *supra* note 19, at 48.

144. *Centurion Corp. v. Crocker Nat'l Bank*, 255 Cal. Rptr. 794 (Cal. Ct. App. 1989).

145. *Id.* at 795.

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

void the order of sale.¹⁵¹ Perroton filed this motion after he filed for bankruptcy and after the bank had obtained relief from the automatic stay in the bankruptcy proceedings which allowed it to sell the interest in the limited partnership.¹⁵² The trial court denied Perroton's motion to void the sale and Perroton appealed.¹⁵³

The appeals court affirmed the ruling of the lower court.¹⁵⁴ The court said that a creditor with a judgment against a partner, but not the partnership, cannot execute directly on the partner's interest in the partnership.¹⁵⁵ However, the court held that the authorities support the order for sale of the judgment debtor partner's interest as distinct from the property of the limited partnership, where the creditor has shown that it was unable to obtain satisfaction of the debt under the charging order and where the general partner has consented to the sale.¹⁵⁶ The court pointed out that the limited partner does not have any property interest in specific partnership interests as such.¹⁵⁷ Rather, the limited partner is entitled, among other things, to receive a share of the profits.¹⁵⁸

The court supported its decision by citing the California Corporations Code and case law. The interest charged may be redeemed at any time before the foreclosure, or, in the case of a sale being directed by the court, may be purchased without thereby causing dissolution: (a) with separate property, by any one or more of the partners; or (b) with partnership property, by any one or more of the partners with the consent of the partners whose interests are not so charged or sold.¹⁵⁹

Also, the court stated that an authoritative treatise about California partnerships said that the judgment creditor does not own the partnership interest by virtue of the charging order but may become the owner by foreclosing the interest. Any one of the partners may, however, redeem the interest before foreclosure or court-ordered sale.¹⁶⁰

151. *Id.*

152. *Id.* at 796.

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.* at 797.

157. *Id.*

158. *Id.*

159. *Id.* at 798 (citing CAL. CORP. CODE § 15028 (West 1991)).

160. *Id.* (citing CONTINUING EDUC. BAR, ADVISING CALIFORNIA PARTNERSHIPS 429 (1988)).

The court also pointed to California cases which, in the court's opinion, indicated that creditors who first obtain a charging order can have the partnership interest sold.¹⁶¹ For example, in *Evans v. Galardi*,¹⁶² the judgment creditor could not get any money by merely getting the charging order.¹⁶³ In *Evans*, the court said it might "permit a deviation from the statutory process."¹⁶⁴

Thus, the *Centurion* court concluded that the California Corporations Code, case law, and relevant authorities allowed it to sanction a sale of the debtor partner's interest if three conditions were met.¹⁶⁵ First, the creditor must obtain a charging order. Second, the judgment nevertheless remains unsatisfied.¹⁶⁶ Finally, all partners other than the debtor partner consent to the sale.¹⁶⁷ The court said that this consent meant that the sale did not violate the partnership agreement.¹⁶⁸

In *Hellman v. Anderson*,¹⁶⁹ Hellman filed lawsuits against Anderson for accounting, breach of fiduciary duty, mandatory injection, rescission, and fraud.¹⁷⁰ In 1987, Hellman and Anderson settled these suits.¹⁷¹ However, Anderson failed to make any of the payments required by the settlement agreements, and in October 1987, the trial court entered stipulated judgments totaling more than \$440,000 against Anderson.¹⁷² In July 1988, after various unsuccessful attempts to enforce the judgments, Hellman obtained an "Order Charging Debtor John B. Anderson's Partnership Interest" in Rancho Murieta Investors (RMI), a general partnership in which Anderson had an eighty percent ownership interest.¹⁷³ In December 1988, Hellman filed a motion for an order authorizing a foreclosure sale of Anderson's partnership interest in RMI.¹⁷⁴ The trial court granted the motion and both parties appealed.¹⁷⁵

161. *Id.*

162. 546 P.2d 313 (Cal. 1976).

163. *Id.* at 321.

164. *Id.*

165. *Centurion*, 255 Cal. Rptr. at 798.

166. *Id.*

167. *Id.*

168. *Id.*

169. 284 Cal. Rptr. 830 (Cal. Ct. App. 1991).

170. *Id.* at 832.

171. *Id.*

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*

The appeals court first held that the relevant California statutes authorized the foreclosure of the partnership interest.¹⁷⁶ The court distinguished a partner's right in specific property of the partnership from their interest in the partnership.¹⁷⁷ The court defined a partner's interest in the partnership as their share of the profits and surplus of the partnership.¹⁷⁸ The court said that prior to California's adoption of the Uniform Partnership Act (UPA), a judgment creditor of a partner whose personal debt (as distinguished from partnership debt) gave rise to the lawsuit could force a sale of the partnership assets.¹⁷⁹

Next, the court noted that California had adopted the UPA and said that a foreclosure would not necessarily violate the underlying policy of the UPA and interfere with partnership business.¹⁸⁰ The court noted that the only thing being sold was the partnership interest, not any of the partnership assets.¹⁸¹

As further evidence of statutory authorization, the court cited the California Code of Civil Procedure, which provides that if a money judgment is rendered against a partner, but not against the partnership, the judgment debtor's interest in the partnership may be applied toward the satisfaction of the judgment by an order charging the judgment debtor's interest pursuant to section 15028 (general partnership) or 15673 (limited partnership) of the Corporations Code.¹⁸²

Section 15028 authorizes the charging order and allows a trial court to "make all other orders . . . which the circumstances may require."¹⁸³ The court cited further language of that section that allowed "judicial authority to order foreclosure and sale of the charged interest because [the statute] further says the interest charged may be redeemed 'at any time *before foreclosure, or in the case of a sale* being directed by the court' may be purchased by nondebtor partners"¹⁸⁴ The court concluded that the plain language of the statute contemplated the possibility of judicial foreclosure and sale.¹⁸⁵

Next, the court held that one of the conditions required in *Centurion* for a foreclosure sale—that the other partners consent—was not

176. *Id.* at 833.

177. *Id.* at 833-35.

178. *Id.* at 834.

179. *Id.*

180. *Id.* at 837.

181. *Id.*

182. *Id.* at 835.

183. *Id.* at 834.

184. *Id.*

185. *Id.* at 834-35.

invariably required.¹⁸⁶ The court reasoned that statutes do not state that nondebtor partner consent is required for foreclosure of the charging order.¹⁸⁷ The court noted that if the legislature wanted to make consent a condition, the legislature could have easily done so.¹⁸⁸

The court concluded that the test is whether the foreclosure would unduly interfere with the business of the partnership.¹⁸⁹ In no case does the creditor gain the assets of the partnership or gain a right to participate in the management of the partnership.¹⁹⁰

Some FLP critics suggest that the effect of the *Centurion* and *Hellman* decisions brings into question whether FLPs can really protect the assets of limited partners of FLPs from creditors.¹⁹¹ They assert that the creditors no longer have the charging order as their sole remedy.¹⁹² Some FLP critics claim that the debtor can no longer reasonably rely on the creditor to await distributions while debtors retain their interest.¹⁹³ Although *Hellman* deals with general partnerships, the court's rationale would likely allow for a foreclosure of an FLP interest because the limited partners have no say in partnership affairs and, therefore, a foreclosure would have little impact on the partnership business.¹⁹⁴

Even without *Centurion* and *Hellman*, critics of the asset-protection features of FLPs suggest that FLP advocates overlook several facts about the use of family limited partnerships for asset-protection purposes.¹⁹⁵ For example, even though a creditor cannot reach the assets of the partnership, neither can the debtor partner.¹⁹⁶ Further, the debtor may not tire of the arrangement, particularly where the debtor requires distributions from the partnership to pay for living arrangements.¹⁹⁷ Finally, these commentators suggest that most courts would disapprove of a device which they may deem is used solely for the avoidance of debt repayment.¹⁹⁸

186. *Id.* at 837.

187. *Id.*

188. *Id.*

189. *Id.* at 838.

190. *Id.*

191. Engel & Rudman, *supra* note 19, at 47.

192. *Id.* at 48.

193. *Id.*

194. *Id.*

195. *Id.* at 47.

196. *Id.*

197. *Id.*

198. *Id.*

In response, other commentators suggest that the general partner can control the timing of distributions and thus the foreclosure really would have no effect.¹⁹⁹ Also, the *Hellman* case involved a general partnership, and, even though the *Centurion* case involved a limited partnership, the court in *Centurion* required that the creditor obtain the consent of the nondebtor partners.²⁰⁰ Finally, the *Hellman* decision makes clear that the foreclosure order does not entitle the creditor to the assets of the partnership or allow the creditor to participate in the management or operation of the partnership.²⁰¹

2. TAX SAVINGS

FLPs save on transfer taxes when a partner transfers assets within the partnership.²⁰² An elderly person, when using an FLP, would transfer assets into the FLP and then reduce the value of these assets, thus reducing the transfer tax.²⁰³

Transfer taxes are generally imposed on the fair market value of the property transferred.²⁰⁴ For transfers where the market value is not readily determinable, federal regulations say that the value "is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having knowledge of the relevant facts."²⁰⁵ Commentators suggest that if this formula is used together with the assumption in the regulation that the parties are unrelated, the value of gifts can be significantly eroded.²⁰⁶ Further, the ability to manipulate the value presents an opportunity to reduce the transfer tax to almost nothing.²⁰⁷ One commentator expressed the situation as an "estate planner's dream."²⁰⁸

An appraiser will calculate a discount that reduces the value of the interest and includes minority-interest discounts, discounts on

199. See, e.g., Oshins, *supra* note 3, at 43.

200. *Hellman v. Anderson*, 284 Cal. Rptr. 830, 831 (Cal. Ct. App. 1991); *Centurion Corp. v. Crocker Nat'l Bank*, 255 Cal. Rptr. 794, 795 (Cal. Ct. App. 1989).

201. *Hellman*, 284 Cal. Rptr. at 838.

202. Oshins, *supra* note 3, at 38. An FLP's primary advantage is that it saves on transfer taxes. *Id.*

203. *Id.* at 46. Through valuation techniques, discussed in the note, the value is reduced.

204. *Id.*

205. 26 C.F.R. § 25.2512-1 (1994).

206. See, e.g., Oshins, *supra* note 3, at 46-48.

207. *Id.*

208. *Id.* at 46.

marketability, and restrictions on disposition.²⁰⁹ Minority interests refer to the fact that interests that are closely held are not valued highly because buyers may not want them.²¹⁰ Lack of marketability refers to the fact that no ready market exists for closely held family limited partnership interests because they are unattractive when compared to publicly traded assets.²¹¹ Restrictions on disposition also reduce the value of the interest because the elderly will often limit how co-owners can transfer the interests and also limit who will be allowed as limited partners.²¹² The combination of these valuation discounts reduces the transfer value of an FLP interest and thus reduces the transfer tax.²¹³

3. CONTROL AND OTHER FACTORS

The elderly often worry about the amount of control they will have over their assets. An elderly person would set up an FLP so that the general partner or partners run the partnership and decide when and whether to make distributions.²¹⁴ Thus, if elderly persons decide to use an FLP, they should choose someone whom they can influence.²¹⁵ Losing control of a general partner results in possible loss of any asset-protection advantages an FLP can provide.

FLPs present problems for Medicaid planning purposes. The assets of the elderly person generally would be counted in determining Medicaid eligibility.²¹⁶ Finally, FLPs do not help in avoiding probate, because unlike a trust, a limited partnership does not rule from beyond the grave.²¹⁷

4. CONCLUSION ON FAMILY LIMITED PARTNERSHIPS

Due to recent California cases, the asset-protection feature of FLPs has been drawn into question. Through valuation techniques, the elderly could reduce the taxable value of an FLP and save taxes. Thus, it is likely that FLP assets would be deemed available for Medicaid qualifying purposes.

209. *Id.* at 46-48.

210. *Id.* at 47.

211. *Id.*

212. *Id.* at 48.

213. *Id.*

214. *Id.* at 41.

215. *See id.*

216. Gilfix, *supra* note 46, at 64.

217. KESS & WESTLIN, *supra* note 2, at 177.

C. Trusts

1. ASSET PROTECTION

Commentators suggest that the more discretionary the trust, the greater the creditor protection of the trust.²¹⁸ For example, a trust with flexible terms provides more in the way of protection than a trust that has the beneficiary as its sole trustee or a trust that provides for fixed distributions rather than discretionary distributions.²¹⁹ To give the trust maximum asset-protection features, commentators suggest that the trust agreement allow distributions subject to the absolute discretion of an independent trustee.²²⁰ Also, settlors should not make themselves the beneficiaries of the trust. Thus, by eliminating the beneficiary's enforceable rights, the rights of the beneficiary's creditors are also curtailed.²²¹

Creditor protection often varies by jurisdiction.²²² For example, in some jurisdictions, a creditor cannot reach the assets of a revocable trust.²²³ In other jurisdictions, creditors can reach the assets of revocable trusts even though the settlor has *not* reserved a beneficial interest.²²⁴

One commentator describes the MegatrustSM concept as "perhaps the greatest asset protection tool that a client can establish."²²⁵ In a MegatrustSM the trustee has broad powers to make distributions.²²⁶ Usually, the trustee provides that beneficiaries can use the assets of the trust but must pay for their own consumables.²²⁷ If the elderly

218. See, e.g., Oshins, *supra* note 3, at 52.

219. *Id.*

220. *Id.*

221. *Id.*

222. AUSTIN W. SCOTT & WILLIAM F. FRATCHER, *THE LAW OF TRUSTS* § 330.12 (1991).

223. See, e.g., *Hill v. Cornall & Bros.*, 95 Ky. 512 (1894); *Guthrie v. Canty*, 53 N.E.2d 1009 (Mass. 1944); *Abruzzese v. Oestrich*, 47 A.2d 883 (N.J. Ch. 1946); *Murphey v. C.I.T. Corp.*, 33 A.2d 16 (Pa. 1943); *Van Steward v. Townsend*, 28 P.2d 999 (Wash. 1934).

224. See ALA. CODE § 35-4-290 (Michie 1991); CAL. PROB. CODE §§ 19000-19403 (West Supp. 1995); IND. CODE § 30-1-9-14 (West 1994); KAN. STAT. ANN. § 67-414 (1993); MICH. STAT. ANN. § 26.155-188 (Callaghan 1993); MINN. STAT. ANN. § 502.76 (West 1990); N.Y. EST. POWERS & TRUSTS LAW § 10-10.6 (West 1992); N.D. CENT. CODE § 59-05-35 (Michie 1993); OHIO REV. CODE ANN. § 1335.01 (Anderson 1993); OKLA. STAT. ANN. tit. 60, § 299.15 (West 1994); S.D. CODIFIED LAWS ANN. § 43-11-17 (Michie 1993); WIS. STAT. § 701.07 (West 1993).

225. Oshins, *supra* note 3, at 61 n.34. The MegatrustSM is a service mark held by Richard Oshins and Jonathon Blattmachr.

226. Richard A. Oshins & Jonathon Blattmachr, *The Megatrust: An Ideal Family Wealth Preservation Tool*, TR. & EST., Nov. 1991, at 22.

227. *Id.* at 23. Consumables can be food, medicine, etc.

beneficiary wants a house, the trust would purchase the home and allow the elderly person to use it.²²⁸

2. TAX SAVINGS

The tax savings of trusts varies from trust to trust.²²⁹ Some trusts save in estate taxes, others in income taxes.²³⁰ For example, revocable trusts offer little tax savings.²³¹ All income from the trust is attributable to the settlor because the settlor can revoke the trust.²³² No estate tax savings exist either, and these taxes are attributed to the estate.²³³

In contrast, irrevocable trusts are not taxable to the settlor's estate.²³⁴ If settlors want to create a living irrevocable trust, they should not include the power to revoke, nor allow anyone else a reversionary interest. They should not retain a general power of appointment, nor should they retain any interest after death, and, if insurance is part of the trust, the estate should not be named the beneficiary.²³⁵ Because the tax in this trust arrangement is distributed,²³⁶ the settlor may save income tax.²³⁷

Grantor retained interest trusts (GRITs) do not save on income tax because all income is attributable to the settlor.²³⁸ Estate taxes are not taxable to the grantor's estate unless the grantor dies within the reserved income term, subject to special rules of I.R.C. section 2036(c) regarding the term of the trust and the property with which it is funded.²³⁹

The income from standby trusts is taxable to the settlor, and the assets of the trust are includable in the settlor's estate.²⁴⁰ Because the income from pour-over trusts is also attributable to the settlor, no income tax savings exist with this kind of trust.²⁴¹ It is possible to save

228. *Id.*

229. KESS & WESTLIN, *supra* note 2, at 201.

230. *Id.*

231. *Id.* at 202-03.

232. *Id.*

233. *Id.*

234. *Id.* at 198-99.

235. *Id.* at 199.

236. *Id.* at 201.

237. *Id.* at 199.

238. *Id.*

239. I.R.C. § 2036(c) (1987).

240. KESS & WESTLIN, *supra* note 2, at 205.

241. *Id.* at 207.

on estate taxes if the trust is an irrevocable rather than a revocable trust.²⁴²

Finally, income is taxed to the creator of testamentary trusts.²⁴³ The assets of such a trust are included in the settlor's estate.²⁴⁴

3. CONTROL AND OTHER ISSUES

The amount of control available to the creator of a trust varies among the trusts.²⁴⁵ In a revocable trust, the settlor enjoys a great degree of control because he or she can revoke the trust arrangement.²⁴⁶ Creators of revocable pour-over trusts enjoy this feature as well.²⁴⁷ On the other hand, settlors of irrevocable trusts will have little control.²⁴⁸ Special-needs trusts, for example, are often set up to provide little control for the settlor.²⁴⁹ For MegatrustsSM and special-needs trusts, effective control depends upon the selection of a reliable trustee.²⁵⁰ Settlors need to pick someone upon whom they can depend because they will have little discretion to change the trust after they create it.²⁵¹

Trusts possess an important feature in that they avoid probate.²⁵² Often, settlors do not want to pay for probate.²⁵³ Also, they may not want their private information made public.²⁵⁴ They also may want to save time.²⁵⁵ Thus, a trust "rules from beyond the grave" and provides a great vehicle by which to avoid probate.²⁵⁶

Some trusts might help with the Medicaid qualifying trust (MQT) problem.²⁵⁷ At first glance, purely discretionary trusts might solve the problem.²⁵⁸ However, in some jurisdictions the government deems assets from these trusts as available.²⁵⁹ One commentator sug-

242. *Id.* at 205.

243. *Id.*

244. *Id.*

245. *See id.* at 201 (comparing trusts generally).

246. *Id.*

247. *Id.* at 206.

248. *Id.*

249. *See Gilfix, supra* note 46, at 63.

250. *See Oshins & Blattmachr, supra* note 226, at 20; *Gilfix, supra* note 46, at 63 (discussing the trustee).

251. *See Oshins & Blattmachr, supra* note 226, at 20.

252. *KESS & WESTLIN, supra* note 2, at 201.

253. *Id.*

254. *Id.*

255. *Id.*

256. *Id.* at 173.

257. *See Buchanan & Buchanan, supra* note 1, at 31.

258. *Id.*

259. *See id.*; see also Schlesinger et al., *supra* note 45, for examples of states that do.

gests that several drafting techniques exist to protect a discretionary trust from being deemed available and thus excluding public support.²⁶⁰ First, the trustee should be provided with absolute discretion to make distributions.²⁶¹ Second, the discretionary trust should convert into a supplemental-needs trust when the beneficiary enters an institution.²⁶² Third, a discretionary trust can provide for beneficiaries in addition to the incapacitated.²⁶³ Fourth, the trust should provide for the distribution of the principal and accumulated income when the beneficiary dies.²⁶⁴ Fifth, the trust instrument should include a spendthrift clause.²⁶⁵ Sixth, the trust should grant a limited power of appointment to a dependable relative.²⁶⁶ Finally, a grantor-beneficiary might retain a special power of appointment exercisable in favor of a class of beneficiaries.²⁶⁷

The elderly also can create a special-needs trust (that explicitly limits a trustee's discretion to nonessential items) to deal with the MQT problem.²⁶⁸ However, some state legislatures have tried to limit the effectiveness of this technique.²⁶⁹

4. CONCLUSION ON TRUSTS

The asset protection features of a trust vary by type of trust. Generally, the less interest a settlor has in a trust, the less a creditor

260. Schlesinger et al., *supra* note 45, at 336. However, individual circumstances must be analyzed carefully before any of these steps are recommended. *Id.*

261. *Id.* To guard against the chance that the trustee may not make any payments to the beneficiary, the trust agreement should contain goals. *Id.*

262. *Id.* at 336-37. This type of trust is known as a convertible trust. *Id.* at 337. Because a "luxuries only" provision limits a trustee's discretion, a court might be persuaded not to invade the trust assets. *Id.*

263. *Id.* This is because if additional beneficiaries are named, a trustee might have sufficient justification to withhold payments from the incapacitated beneficiary. *Id.*

264. *Id.* This gives the trustee further justification to withhold distributions and further reason for a court not to deem the assets available. *See id.*

265. *Id.* A spendthrift clause states that the trust assets are not available to creditors and cannot be alienated by the beneficiaries. Even though this clause might not defeat the interests of all creditors, it should stop the claims of those not supplying necessities to the beneficiary. *Id.*

266. *Id.* at 338. The assets over which the power of appointment is exercised are not available resources. *Id.*

267. *Id.* The trust instrument could be drafted so that the exercise of power over the assets when the grantor becomes eligible for aid terminates income to the grantor. *Id.*

268. Gilfix, *supra* note 46, at 62-64.

269. *Id.* For example, a New Jersey statute states, "Any provision in a . . . trust agreement . . . which reduces or excludes coverage or payment for goods and services to an individual because of that individual's eligibility for or receipt of Medicaid benefits shall be null and void." N.J. STAT. ANN. § 30:4D-6f (West 1981).

can reach. Taxes also vary by trust type. Settlor can save on estate or income taxes depending upon which trust they select. Control also varies among trusts. A settlor can have the complete control a revocable trust offers or have the very little control an irrevocable trust offers. Finally, some trusts can surmount the MQT problem. However, the availability of these trusts often varies by jurisdiction.

D. Limited Liability Corporations

1. ASSET PROTECTION

The limited liability corporation affords limited liability to its members; the members are liable for the amount of their contribution only, and they maintain control and management of the corporation.²⁷⁰ The Wyoming LLC statute features a typical example of how an LLC would limit the liability of its members: neither the members of the limited liability company, nor the managers of a limited liability company managed by a manager or managers, are liable under any judgment, decree, or order of a court, or in any manner, for debt, obligation, or liability of the limited liability company.²⁷¹ Most states that have adopted LLCs have similar provisions.²⁷² Thus, the elderly could make a family business into an LLC. If the business were sued, they would not be personally liable.

2. TAX ISSUES

The main issue for tax purposes regarding LLCs is whether the government classifies LLCs as corporations or partnerships. While they were classified as corporations, they languished as a financial planning vehicle.²⁷³

Commentators refer to limited partnerships and some trusts as *pass-through* entities.²⁷⁴ The government does not tax the entity itself, but rather taxes those who receive the money from the entity.²⁷⁵ On the other hand, the government considers a corporation a taxable entity.²⁷⁶ In fact, the IRS subjects the shareholders of a corporation to double taxation because both the corporation and the shareholder pay

270. Geu, *supra* note 3, at 50.

271. WYO. STAT. § 17-15-113 (Michie Supp. 1994).

272. Geu, *supra* note 3, at 50.

273. See Thomas E. Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer* (pt. 2), 37 S.D. L. REV. 467, 469 (1992).

274. *Id.*

275. *Id.*

276. *Id.* at 470.

tax on the corporation's income.²⁷⁷ Thus, from a tax standpoint, an elderly person would want the LLC classified as a pass-through entity like a trust or partnership rather than as a taxable entity like a corporation.²⁷⁸

In *Morrissey v. Commissioner*,²⁷⁹ the Supreme Court listed five factors to determine whether an organization would be classified as a corporation for tax purposes.²⁸⁰ These factors were: (1) the holding of title by either the organization or its agents; (2) whether "centralized management" was present; (3) the ability to transfer interests in the organization without interruption of the organization during the lifetime of the owner of the interest; (4) continuity of the organization; and (5) the limited liability of the owners.²⁸¹

The court in *Larson v. Commissioner* determined the weight of the *Morrissey* factors.²⁸² In *Larson*, the IRS sought to classify a limited partnership as a corporation.²⁸³ The legal question was the weight to be accorded to the *Morrissey* factors.²⁸⁴ The court concluded that it would use a balancing test and weigh the factors to see if there were more corporate than noncorporate factors.²⁸⁵ The court determined that it would give equal weight to each factor in the determination.²⁸⁶

During the early 1980s, LLCs were classified as partnerships.²⁸⁷ In 1982, the IRS changed the LLC classification to corporation. The LLC lay dormant as a planning tool until 1988. In Revenue Ruling 88-76, the IRS decided that it would classify a Wyoming LLC as a partnership for tax purposes.²⁸⁸ The Service decided that the LLC lacked two of the four requirements for corporations.²⁸⁹ First, they said that the LLC lacked the continuity-of-life requirement because, under the Wyoming Act, the LLC dissolves.²⁹⁰ Second, the members of the LLC could not freely transfer their interest in the LLC because they could

277. *Id.*

278. *See id.* at 471.

279. 296 U.S. 344 (1935).

280. *Id.* at 359-60.

281. *Id.*

282. 66 T.C. 159 (1976).

283. *Id.* at 159.

284. *Id.* at 172.

285. *Id.*

286. *Id.*

287. *Ale, supra* note 95, at 35.

288. Rev. Rul. 88-76, 1988-2 C.B. 361.

289. *Id.*

290. *Id.*

only assign the right to share in the profits.²⁹¹ Although the LLC, in that case, did possess the characteristics of limited liability and centralized management, it lacked a preponderance of corporate characteristics.²⁹² Thus, the Service classified it as a partnership and not as a corporation for tax purposes.²⁹³

3. CONTROL AND OTHER ISSUES

The main disadvantage of the LLC is the restricted transferability of the interest a person holds in an LLC.²⁹⁴ Of course, this is not a problem if elderly persons never want to transfer their interest in the LLC. However, if they do want to transfer it, they can, as in a partnership, only transfer their right to share in the profits and not any of the other rights of membership such as the right to participate in the management of the LLC.

4. CONCLUSION ON LIMITED LIABILITY COMPANIES

The LLC affords its members limited liability; generally, a member is liable only to the extent of his or her contribution for any LLC debt. LLCs are not subject to the double taxation of corporations because several IRS rulings have determined the LLC should be taxed as a partnership. Finally, LLCs seem to offer more control than trusts. However, the interest in an LLC is not readily transferable.

IV. Recommendations: A Proposal for How the Elderly Should Use the FLP, Trust, and LLC

An elderly client, whether contemplating nursing home care or not, should not use FLPs because California court decisions have chipped away at the asset-protection advantages of this financial planning device. Instead, elderly individuals should use a combination of trusts and limited liability companies to maximize asset protection, tax savings, and control. A combination of trusts and LLCs also minimizes probate, and the special-needs trust might solve the MQT problem.

291. *Id.*

292. *Id.*

293. *Id.*

294. *Id.* A person cannot transfer assets in the LLC without the unanimous consent of the other members, but only the right to share in the profits of the LLC.
Id.

The *Centurion* and *Hellman* decisions cast a cloud over the future of asset-protection advantages of the FLP.²⁹⁵ Whereas before the only remedy for a creditor was a charging order, the courts in these cases allowed the creditor to foreclose on the interests and thus reach the interests themselves.²⁹⁶ Furthermore, FLP proponents overlook several other negative facts about FLPs.²⁹⁷ For example, even if a creditor cannot reach the FLP interest, neither can the elderly debtor.²⁹⁸ Also, debtors may not tire of the arrangements as easily as FLP proponents think.²⁹⁹ This may be particularly true when distributions pay the elderly's living expenses, so that the general partner cannot wait to make distributions.³⁰⁰

Trusts can provide more in asset protection if the creator of the trust makes the trust totally discretionary. Trusts are also helpful in saving taxes.³⁰¹ They are flexible enough to provide as much tax savings as the creator wants.³⁰² Trusts can surmount the MQT problem and help elderly clients who are trying to qualify for Medicaid.³⁰³ Trusts also can provide as much control as the grantor wishes. If the grantor wants no control, the planner can use some kind of irrevocable arrangement. On the other hand, a revocable trust can be used if the grantor wants to retain control over his or her property.³⁰⁴

Limited liability companies add a new dimension to financial planning for the elderly. Ideally suited for elderly persons with risky businesses and professional relationships (e.g., lawyers, doctors, accountants), LLCs provide for the same limited liability that a corporation provides.³⁰⁵ Unlike a corporation, the government does not subject LLCs to double taxation, and, therefore, they have a partnership's tax advantages.³⁰⁶

Thus, this note recommends that the elderly client avoid the FLP arrangement and instead use a combination of LLCs and trusts to

295. Engel & Rudman, *supra* note 19, at 47.

296. *Id.*

297. *Id.*

298. *Id.*

299. *Id.*

300. *Id.*

301. See KESS & WESTLIN, *supra* note 2, at 201.

302. *Id.* at 173.

303. Buchanan & Buchanan, *supra* note 1, at 31.

304. See KESS & WESTLIN, *supra* note 2, at 202.

305. Geu, *supra* note 3, at 45.

306. Geu, *supra* note 273, at 470.

maximize asset protection, tax savings, control, probate reduction, and Medicaid eligibility.

Several criticisms of this proposal exist. For example, the elderly might still use FLPs because the *Centurion* and *Hellman* decisions could be limited to their specific facts.³⁰⁷ For instance, the *Centurion* case contained a limited partnership, and the court required the other partners' consent to the foreclosure.³⁰⁸ However, the court in *Hellman* explicitly rejected any consent requirement.³⁰⁹

In *Hellman*, the partnership was a general partnership.³¹⁰ In that case, the court worried that the foreclosure would impact the business of the partnership.³¹¹ One commentator has pointed out that the logic in *Hellman* is even more applicable to limited partnerships because limited partners have little say in partnership affairs, so the foreclosure of such interests would have little impact on the business of the partnership.³¹² Thus, a court might be even more willing to apply *Hellman* to a limited partnership which is a family business.³¹³

Another criticism is that trusts are in fact not suited to surmount the MQT problem because of court decisions and legislation.³¹⁴ For example, in *Tutino v. Perales*,³¹⁵ the settlors set up an irrevocable trust which contained substantial assets.³¹⁶ One paragraph of the trust stated that the purpose of the trust was to preserve the trust assets so that the income coming from the trust would pay "all of the ordinary living expenses" of the settlors.³¹⁷ At the death of both the settlors, the corpus of the trust would be distributed to the children of the settlors.³¹⁸

In 1984, one of the settlors died.³¹⁹ The other settlor, apparently unable to handle her own affairs, entered a nursing home.³²⁰ She applied for public assistance but was denied because the state of New York required that she assign her rights in the trust to the state before

307. Engel & Rudman, *supra* note 19, at 48.

308. *Id.*

309. *Hellman v. Anderson*, 284 Cal. Rptr. 830, 837 (Cal. Ct. App. 1991).

310. *Id.* at 832.

311. *Id.* at 834.

312. Engel & Rudman, *supra* note 19, at 48.

313. *Id.*

314. Buchanan & Buchanan, *supra* note 1, at 31.

315. 550 N.Y.S.2d 21 (N.Y. App. Div. 1990).

316. *Id.* at 22.

317. *Id.*

318. *Id.*

319. *Id.*

320. *Id.*

she could receive state assistance.³²¹ The court held that the settlor had to first provide for her own assistance and that the requested assignment was not coercive.³²² The court distinguished between this case and other cases by noting that in other cases where assistance was not denied, the trusts were: (1) testamentary in nature; (2) the testator would ordinarily have no obligation to otherwise support the beneficiary; and (3) the testator would not have consented to the invasion of the principal before the exhaustion of public funds.³²³ The court concluded that these considerations are inapplicable where the settlor herself is the individual whose medical needs prompted the application.³²⁴

Critics of relying on trust arrangements to surmount Medicaid eligibility problems might also point to legislation in different states that tries to limit the effectiveness of special-needs trust techniques.³²⁵ For example, New Jersey's statute states, "Any provision in a . . . trust agreement . . . which reduces or excludes coverage or payment for goods and services to an individual because of that individual's eligibility for or receipt of Medicaid benefits shall be null and void."³²⁶

Despite this decision and legislation, a testator can create a testamentary trust and still receive public funds.³²⁷ A planner might use a trust established for the applicant's benefit by relatives or a court as another solution to this problem.³²⁸

Finally, critics of LLCs might say that LLCs remain untested and really do not offer much advantage over FLPs. However, their main attributes of tax savings and limited liability have been tested and seem secure.³²⁹ The certainty LLCs provide contrasts with the cloud of uncertainty that hangs over FLPs in the wake of the *Centurion* and *Hellman* decisions. Elderly clients are probably the least willing to want to confront uncertainty.

321. *Id.*

322. *Id.* at 24.

323. *Id.* at 25.

324. *Id.*

325. Buchanan & Buchanan, *supra* note 1, at 31.

326. N.J. STAT. ANN. § 30:4D-6f (West 1981).

327. See Schlesinger et al., *supra* note 45, at 332.

328. Buchanan & Buchanan, *supra* note 1, at 31.

329. The limited liability features of an LLC are provided in statutes.

V. Conclusion

This note explored whether elderly persons should use family limited partnerships, trusts, or limited liability companies. It evaluated the effectiveness of these techniques in view of recent court cases and statutes and concluded that FLPs should not be used by elderly clients. This is primarily because of the *Hellman* and *Centurion* decisions, which cast a cloud over the asset-protection features of the FLP.

This note concluded that trusts still offer more asset protection than FLPs. Trusts offer the most in asset protection when a planner designs them to give much discretion to the trustee. Also, an elderly person can use a trust to save on the type of taxes that the elderly person is most interested in saving. For example, many irrevocable trusts save in estate taxes. Finally, one can design trusts to get around the Medicaid qualifying problem. An elderly person can use a special-needs trust to surmount this obstacle to obtaining Medicaid funds.

LLCs provide for limited liability and offer the certainty FLPs lack. The government classifies LLCs as partnerships, thus taxing the LLC only once. Yet, they offer limited liability as well. Shareholders of LLCs will be liable only for the amount of their contribution to the LLC. Thus, the LLC offers the tax advantages of a partnership and the asset-protection advantages of a corporation. Although the LLC is a new device, the elderly would do well to consider it in furthering their financial goals.