# State Law & State Taxation Corner

*By Thomas E. Rutledge*

## Charging Orders: Some of What You Ought to Know (Part II)



Part I of this Article introduced some of the issues of the charging order, including their history, the statutory formulas and issues of the judgment creditor *vis-à-vis* the partnership.[1] Herein, we continue the review of the charging order, focusing on matters external to organizational law.

### Taxation, or Whose Income is it Anyway?

The taxation of the funds directed to the creditor by a charging order is not expressly addressed by the Code, but the consensus answer is that the member/partner who is charged remains a "partner" for all purposes of the tax code (just as they are for purposes of state laws) and is responsible for all taxes due on allocated income. The fact that the distribution, if and when made, will be paid over to the judgment debtor does not affect who bears the initial tax liability. Put another way, the member/partner whose interest is charged will satisfy their judgment creditor with after-tax, and not pre-tax, dollars.

Consider ABC partnership. It distributes all of its earnings each year, so we are not concerned with a distribution this year to a partner of a prior year's after-tax dollars. B is the defendant in a suit, and loses. B's judgment creditor ("Creditor") is seeking to collect on the judgment. B's assets are illiquid, and B's only source of current income are the distributions made by ABC. Creditor applies for, and receives, a charging order that directs ABC to pay to her B's distributions from ABC. In the current year, $40,000 is paid by ABC to Creditor in partial satisfaction of the judgment.

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So what happens when the time comes to prepare the K-1? Notwithstanding assertions to the contrary,[2] B's K-1 should reflect an allocation of $40,000, for which she bears the tax liability, and Creditor should not receive a K-1. Absent extraordinary circumstances, Creditor is not a partner and is not receiving either a portion of partnership income or a guaranteed payment. Rather, Creditor is receiving B's property to satisfy a judgment. The resolution is based, in part, on GCM 36960[3] and Rev. Rul. 77-137,[4] each of which state that the test for who bears the tax liability is who possesses dominion and control over the partnership interest giving rise to the allocable income. As stated in one partnership tax treatise:

> An essential factor in the Revenue Ruling [77-137] was that in addition to assigning the partnership interest, the assignor-partner also agreed to exercise any residual rights and powers remaining to the assignor as the nominal partner in favor of and for the benefit of the assignee. The Ruling concluded that the assignee therefore had the requisite "dominion and control" over the interest necessary for the assignee to be treated as a partner.[5]

Creditor holds a right to receive from ABC the distributions that would go to B, a right that will be extinguished when the judgment is satisfied. At that point, B will again receive the distributions. In the meantime, B has not lost the right to participate in the management of ABC, Creditor has no control over ABC or its assets, Creditor is not substituted for B as a partner,[6] and B is not bound to exercise her management rights for the benefit of Creditor.[7] On these facts, Creditor does not have "dominion and control" over B's interest in ABC. Creditor has not become, for tax purposes, a substitute general partner, and the initial tax liability on the distributions shifted to Creditor remains with B.[8]

The situation changes upon the foreclosure of B's interest and its purchase by either Creditor or another stranger to ABC.[9] Purchaser will be an assignee of B's interest in ABC,[10] and it is Purchaser who should be deemed to have "dominion and control" over the transferable interest acquired in ABC. While Purchaser will have only the rights of an assignee (unless admitted as a partner by A and C), such should be sufficient to constitute her a "partner" for tax purposes even though she is not a "partner" for purposes of the partnership act.[11]

## Charging Order in Bankruptcy– *Albright & Ehmann*

Whether and to what degree a bankruptcy trustee for a bankrupt partner is limited to the charging order is open to some dispute, but the recent trend in the case law (to the extent two decisions are a trend) is that not only is the trustee *not* limited to the status and rights of a holder of a charging order, but that neither is the trustee treated as an assignee. Rather, the trustee may exercise all rights of a partner.

*In re Albright*[12] involved the bankruptcy of Ashley Albright, the sole member of a Colorado LLC. Her trustee sought to access the assets of the LLC to satisfy her debts (in effect a reverse veil piercing). Albright resisted, arguing that the trustee should be limited to a charging order and receipt of the distributions that would otherwise be made to Albright. The bankruptcy court rejected that argument, noting that in the SMLLC context there are no other members whose interests need to considered *vis-à-vis* a transfer of both the economic and the management rights of management. On that basis, the trustee was allowed to exercise control of the LLC, and presumably, to liquidate its assets and apply the proceeds to satisfy Albright's debts.[13]

*In re Ehmann*[14] involved Greg Ehmann, a member of Fiesta Investments LLC, an Arizona limited liability company. He went into a personal Chapter 7 bankruptcy; Fiesta Investments was not itself in bankruptcy. The bankruptcy trustee sought to exercise all of Ehmann's rights as a member of Fiesta Investments, including the right to object to the management of the company outside the terms of the operating agreement and to seek a receivership and liquidation of the LLC in order to generate funds to satisfy Greg's creditors. Fiesta argued that the trustee was limited to the rights afforded the holder of a charging order. The bankruptcy court ultimately determined that not only was the bankruptcy trustee not restricted to the rights of the holder of a charging order, but rather that the trustee could exercise all of the rights of a member of the LLC.[15]

*In re Albright* may properly be restricted to its relatively narrow facts, namely the bankruptcy of the sole member of an LLC, and while its reasoning path is easily criticized, its ultimate conclusion appears sound. *In re Ehmann* indicates that, even in a multiple-member LLC, the bankruptcy trustee is not restricted by the charging order, a conclusion that is open to significant debate.

## "Garnishment Limits" on Charging Orders

Let us return to ABC partnership, B's debt to Creditor and the charging order issued against B's interest in favor of Creditor. Again, B's only source of current income is the distributions from ABC. If B were a mere employee of ABC, she would be receiving wages,[16] and a garnishment issued against her wages would have a statutory limit.[17] But partnership distributions may not be earnings. For example, in *Roberts v. Frank Carrithers & Bros.,*[18] it was held that salary and wages meant consideration paid by an employer to one who is serving him, and the terms are not applied in describing gain, profit or recompense which accrues to one conducting a business on his own account. In this situation, the gain realized on the sale of tobacco by a farmer for his own account was a business venture that did not generate wages.

More recently, it has been held that distributions by a LLC to its members may in fact constitute wages that are protected by garnishment order limits. In *Zavodnick v. Leven,*[19] the Court held that a charging order is subject to statutory limits on execution against wages, reasoning that "although the distributions to [the debtor partner] from partnership profits are not 'wages' or 'salary,' they are unquestionably 'profits due and owing. . . . which play substantially the same role in the partner's life as an employee's wages. The partner typically depends on such distributions to purchase food, shelter and other necessities for himself and his family." Furthermore, "if [the partner] were an associate rather than a partner any wage garnishment clearly would be subject to the limitations of [the wage execution statute]. Similarly, if [the debtor partner] were a sole practitioner, the income he derived from his practice would constitute 'earnings' within the intent of the statute." Therefore, the Court concluded, that "distributions from the partnership through which [the partner] has chosen to practice his profession are subject to the same limitation on executions ... as an employee's wages or a sole proprietor's earnings."

In assessing the *Zavodnick* decision, it is important to recognize that the New Jersey garnishment exemption statute included "profits due and owing."[20] The degree to which a charging order will be subject to the garnishment limits is going to be state law specific and requires study of the garnishment statute in question.

## The Charging Order in the Debtor's Bankruptcy

Having successfully represented Creditor in her suit against B and received the requested charging order, you now have to worry about whether B will file bankruptcy and by doing so avoid liability on the judgment.

RUPA §504(b) states that a charging order "constitutes a lien on the judgment debtor's transferable interest in the partnership."[21] In order for that lien to be perfected, the charging order needs to be obtained prior to the filing of the bankruptcy petition.[22] A mere application for a charging order only starts the judicial process for perfecting a lien against a partnership interest; perfection of the lien occurs when a court actually enters a charging order.[23] The *Rooker-Feldman* doctrine prevents the bankruptcy court from reviewing state court judgments, so the bankruptcy court may not review either the underlying judgment against B or the propriety of the court's award of a charging order in Creditor's favor.[24] A discharge under 11 USC §§727, 1141, 1228(a), 1228(b) or 1328(b) does not discharge a debtor from any final judgment, unreviewable order or consent order or decree entered in any court of the United States or of any state.[25] Therefore, a charging order, which is both an unreviewable order and a perfected lien, should not be discharged in bankruptcy. Be aware, however, that older acts (and some newer) may not contain the "constitutes a lien" language.[26] In those instances, the charging order may not constitute a pre-petition lien, and the judgment creditor holding a charging order risks having the underlying judgment discharged.[27]

## Conclusion

The charging order is a multi-faceted provision impacting the rights of creditors, the rights of debtors, and the rights of the partnership. Tax, bankruptcy and garnishment law, in addition to the statutory language in question, all impact its use as either a sword or a shield. And that is all some of what you should know about charging orders.

## ENDNOTES

[1] Thomas E. Rutledge, State Law & State Taxation Corner, *Charging Orders: Some of What You Ought to Know (Part I),* J. PASSTHROUGH ENTITIES, March–April 2006, at 15.

[2] For example, the website of one company in the asset protection industry asserts:

> The Internal Revenue Service has also held in Revenue Ruling 77-137 that the creditor with the charging order is treated as a substituted limited partner for tax purposes. As a result, the judgment creditor is saddled with the tax consequences resulting from ownership without the capacity to force dissolution of the partnership or distributions from the partnership.

[3] GCM 36960 (Dec. 20, 1976).

[4] Rev. Rul. 77-137, 1977-1 CB 178. *See also* Reg. §1.704-1(e)(2)(ix); Robert R. Keatinge, *Transfers of Partnership and LLC Interests - Assignees, Transferees, Creditors, Heirs, Donees, and Other Successors*, §504.3, in PROCEEDINGS OF THE 32ND ANNUAL PHILIP E. HECKERLING INSTITUTE ON ESTATE PLANNING (1998).

[5] WILLIS, PENNELL & POSTLEWAITE, PARTNERSHIP TAXATION ¶ 2.02[8][e] *(current through 2004 Supp. No. 2).*

[6] *See, e.g., Nigri v. Lotz*, Ga. CtApp, 216 GaApp 204, 453 SE2d 780, 782 (1995), *citing* BROMBERG & RIBSTEIN ON PARTNERSHIP.

[7] *Contrast* LTR 8440081 (July 6, 1984) (assignor agreed to vote retained voting rights in accordance with assignee's written instructions).

[8] *See also* Keatinge, *supra* note 4 ("[w]here the charging order is similar to a garnishment, the debtor/partner will probably be treated as the partner, required to include the distributive share of income and loss and entitled to a deduction if the payment of the judgment would give rise to a deduction"); Christopher M. Riser, *Tax Consequences of Charging Orders*, 1 ASSET PROTECTION J. 14 (Winter, 2000); CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES—TAX AND BUSINESS LAW ¶ 8.07[1][a][ii].

[9] Another possibility is that the purchaser is another partner utilizing personal (and not partnership) assets with which to acquire B's interest in ABC. RUPA §504(d); ULPA §703(c)(2).

[10] RUPA §504(b); ULPA §703(b).

[11] *See* BISHOP & KLEINBERGER, *supra* note 7. This result should apply regardless of whether A and C expel B from the partnership. RUPA §601(4)(ii); ULPA §601(b)(4)(B). *See also* Rev. Rul. 77-332, 1977-2 CB 483 (discussing non-CPAs in accounting firms who for state law purposes are not partners but who are partners for tax purposes).

[12] *In re Albright,* DC Colo., 291 BR 538, Case No.01-11367 ABC.

[13] *See generally* Thomas E. Rutledge and Thomas Earl Geu, *The Albright Decision—Why a SMLLC is Not an Appropriate Asset Protection Vehicle,* 5 Business Entities 16 (Sept./Oct., 2003). *See also FTC v. Peoples Credit First, LLC,* DC Fla., 2006 U.S. Dist. LEXIS 25893 (May 3, 2006) (Order of liquidation awarded against several non-party LLC's owned by individuals against whom are the Federal Trade Commission had obtained a judgment. In holding that, with respect to assertion that charging order was sole remedy, "Under the circumstances, the purposes of the statute are not defeated by the proposed liquidation of the assets of the these companies which presently all [sic] under receivership.")

[14] *In re Ehmann*, BC DC Ariz., 319 BR 200 (2005), *aff'd,* 334 BR 437, *withdrawn* 337 BR 228.

[15] *See generally* Thomas Earl Geu and Thomas E. Rutledge, *Guess Who's Coming to Dinner?: The Bankruptcy Trustee's Ability to Become a Member and the Ehmann Decision*, 7 Business Entities 32 (March/April, 2005); Thomas Earl Geu and Thomas E. Rutledge, *In re Ehmann II—Now You See It, Now You Don't*, 8 Business Entities 44 (May/June 2006).

[16] For example, KY. REV. STAT. §427.005(1) provides that "the term 'earnings' means compensation paid or payment for personal services, whether denominated as wages, salary, commission, bonus, or otherwise, and includes periodic payments pursuant to a pension or retirement program." Various of the unincorporated business organization acts recognize that exemption laws may apply to limit a charging order. *See* RUPA §504(d) ("This Act does not deprive a partner of a right under exemption laws with respect to the partner's interest in the partnership."). *See also* ULPA §703(d).

[17] *See, e.g.,* KY. REV. STAT. §427.010(2)(a) (garnishment limited to 25 percent of disposable earnings).

[18] *Roberts v. Frank Carrithers & Bros.,* 180 Ky. 315, 202 SW 659 (1918).

[19] Zavodnick v. Leven, NJ Super, 340 NJSuper 94, 773 A2d 1170 (2001).

[20] N.J.S.A. §2A:17-56.

[21] RUPA §504(b). *See also* ULPA §703(b).

[22] *In re Raiton*, CA-9 BAP, 139 B.R. 931, 935 (1992) ("A charging order entered pursuant to California's Uniform Partnership Act §15028 replaces a levy of execution and provides the judgment creditor with a lien on the partnership property."); *In re Stocks*, BC DC Fla., 110 BR 65, 67 (1989); *In re Pischke*, BC DC Va., 11 BR 913, 918 (1981); *Krauth v. First Continental Dev-Con, Inc.*, Fla. App., 351 So2d 1106, 1108 (1977); *City of Arkansas City v. Anderson*, 242 Kan. 875, 752 P2d 673, 684 (1988) (issuance and service of the charging order upon the partnership creates a lien on the debtor partner's partnership interest).

[23] *In re Jaffe*, BC DC Fla., 235 BR 490, 492 (1999); *In re Bridgeman*, BC DC Conn., 197 BR 19, 22 (1996) ("[D]eputy sheriff's act of leaving copy of order of attachment in hands of debtor's partner was ineffective to lien debtor's partnership interest; in-court statements of creditor and debtor, indicating agreement to terms of consent order, did not constitute charging order.").

[24] *In re Keeler,* BC DC Md., 273 BR 416, 422 (2002). c*iting Dewsnup v. Timm*, 502 SCt, 502 US 410, 416, 112 SCt 773, Bankr. L. Rep. ¶74,361 (1992); *Cen-Pen Corp. v. Hanson*, CA-4, 58 F3d 89, Bankr. L. Rep. ¶76,549 (1995). The *Rooker-Feldman* doctrine, as well as *res judicata*, bars the bankruptcy court from reviewing final orders of a state court with competent jurisdiction. *In re Keeler*, BC DC Md., 257 BR 442, 446 (2001), *aff'd, In re Keeler*, BC DC Md., 273 BR 416 (2002) (The question of review was "whether the bankruptcy court abused its discretion by not reviewing the legality of the state court charging order."). 273 B.R. at 418, n.1.

[25] 11 USC §523(a)(11).

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt …
> (11) provided in any final judgment, unreviewable order, or consent order or decree entered in any court of the United States or of any State, issued by a Federal depository institutions regulatory agency, or contained in any settlement agreement entered into by the debtor, arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union ….

[26] *See, e.g.*, UPA §28(1); RULPA §703; KY. REV. STAT. §275.260 (Kentucky LLC Act charging order provision adopted in 1998 without lien or foreclosure language).

[27] *See, e.g., Monroe v. Berger*, DC Ohio, 297 BR 97 (2003).