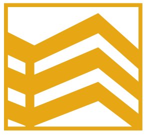

Greenberg & Co.
the business of law

Asset Protection Planning Structures

Whether your net worth places you in the wealthy, or simply comfortable categories, the fact is that you own valuable property that you want to keep. For that reason, it is well worth your time to meet with a qualified attorney to discuss protecting your assets. Not surprisingly, since everyone has different assets, there is no panacea,no "one size fits all" protection plan that will adequately safeguard your property from creditors. Rather, effective planning requires a proper fit between what you should protect and how you should protect it. The structure of an asset protection plan can be relatively simple or highly sophisticated, depending on such variables as

- whether you are in a high-risk profession: one that is prone to lawsuits (such as stockbroker, doctor, financial planner, etc.),
- whether you have material (over $500,000) liquid assets or total assets over $1 million,
- whether you are an owner or partner in a closely held business, and
- whether you are married or contemplating marriage.

An effective plan may incorporate several protection elements that address your needs. To begin the planning process, you will first need to identify your assets.

Asset Inventory

What are your assets? Anything of commercial value, that can be liquidated or converted into cash, or may ever be worth something, is an asset. Common examples include (1) your house or vacation home; (2) car or boat; (3) collectables; (4) jewelry; (5) children's college fund, stocks and bonds, savings account or certificates of deposit; (6) interest in a partnership, trade or business; (7) copyright or patent ownership; and (8) retirement plans or life insurance policies.

Each of these interests represents property that may be seized by your creditors.Certain assets carry higher risks of creditors' attacks than others because the assets themselves are more commonly the source of lawsuits, and it is recommended that you separate those high-risk assets from low-risk assets. For example, if you own commercial real property, such as an office building or an apartment complex, you maybe a target for "slip and fall" or other civil lawsuits. For other assets, like stock ownership in a large public corporation, your liability is usually limited to losing the price you paid for it, should its value plummet.

Depending on which state you live in, there are statutory protections in place that either permit creditors to reach certain assets, or bar creditors from doing so,particularly in the areas of homesteads, annuities, cash values of life insurance,retirement plans, and spousal property. Federal law also dictates certain protections for qualified retirement plans (401k, IRA, or others). If you live in a community property state, the laws governing creditors' claims are very different from those instates that follow the common law.

The Structures

To help illustrate how asset protection planning structures are formed, we'll use some simple examples, to illustrate how a flexible plan can accommodate new and more complex protection approaches if the need arises. (Not every reader will requir eeach of these elements to maintain an effective asset protection plan. We recognize that there are other considerations (i.e., complexity, control, taxes, etc.) supporting whether or not our fictional characters will follow each of these steps, but the examples presented will help illustrate the concepts.)

Domestic Structures

Our fictional clients, Al and Betty Smith, have been married for 20 years. They have paid off the mortgage to their home, which has appreciated in value to $600,000.Having no known creditors, yet desiring to take advantage of the protection and tax savings that apply to family limited partnerships, Al and Betty decide to form the Smith Family Limited Partnership, and transfer ownership to the house (title), their personal stock portfolio, and their children's college fund to the partnership as owner.1 Al and Betty formally have an attorney draft the agreement appointing themselves general partners to retain control over decisions concerning the house and the stocks.

Their four children are named limited partners, each with a share, say 5% interest, in the house's value. Al and Betty each own 40% interest. Over time, Al and Betty intend to transfer more of their collective share to their children (such parent-child transfers can be tax-free if the amount does not exceed $11,000 per child per year, per parent),resulting in the children's ownership once they are adults.

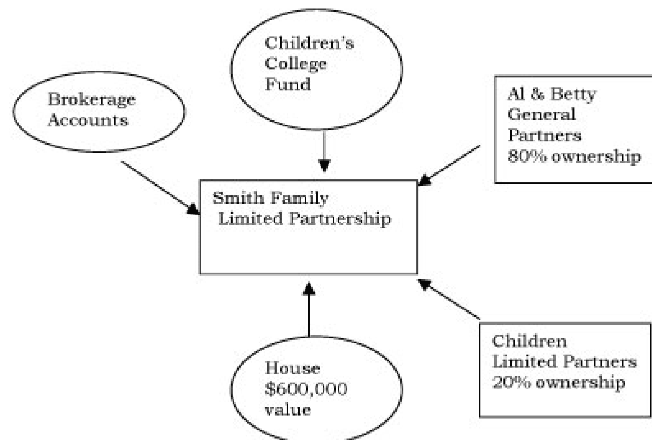

Figure 1

Good move, they think, and they are on the right track. But they are not finished protecting their assets.

By gifting their ownership interests to the Smith Family Limited Partnership, Al and Betty might better protect these assets from the reach of their personal creditors, to the extent of their ownership. However, any transfers need to be done with the effect of gift taxes in mind.

Although the Smith Family Limited Partnership provides some protection from creditors' claims, there may be potential trouble with Al's and Betty's collective 80% interest in the house, as well as their ownership of the brokerage accounts, because Al and Betty are general partners. Eddie, their outgoing sixteen-year-old son, is now driving. In the event that he has a serious accident and someone is severely injured, Al and

Betty are at risk of liability suits and for resulting damages. If their insurance is inadequate, their home is a target that creditors will seek to seize. As general partners, their 80% stake in the home is exposed.

Knowing to anticipate the unexpected well before it happens, Al and Betty take their shares of the partnership's assets and shield them using a limited liability company, ABC, LLC, which they have formed. ABC, LLC becomes general partner in the Smith Family Limited Partnership, with a 1% interest. Al and Betty continue to manage ABC, LLC to retain control over the partnership assets. If Al and Betty, as Eddie's parents, are sued for damages resulting from Eddie's accident, their house is unreachable by creditors. And because Al and Betty complied with the formalities required of a limited liability company (such as keeping separate accounts), ABC, LLC most likely will not be liable.

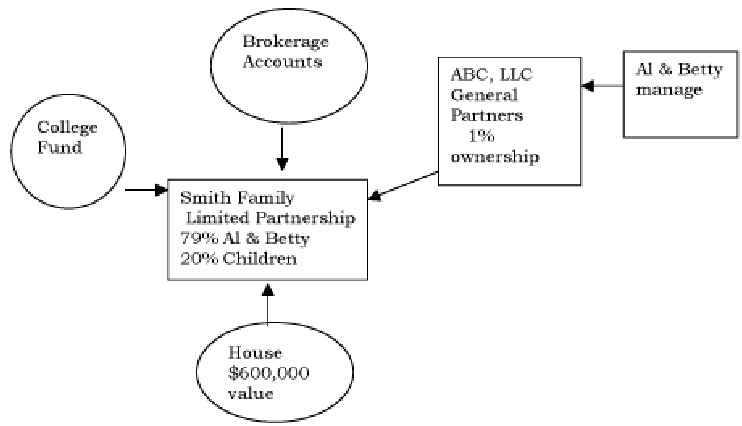

Figure 2

Another asset that Al owns is a chain of local dry cleaning businesses, Town Cleaners. When he started the business some years ago, he had a partner. Al and his partner did not incorporate their business. They have a falling out, and Al buys out his partner for the amount of his original investment ($350,000). Now, Al contemplates whether to

operate the business as a sole proprietor, or to incorporate. If he were sole proprietor,the business would have no separate identity from Al the person, and in the eyes of his creditors, it is Al. If his business suffers fire damage, his insurance should cover costs to rebuild. However, that may not be the case for all of the claims from the irate customers whose one-of-a-kind designer clothing is destroyed: Al's personal assets are at risk to pay those damages. Knowing to foresee an unlikely lawsuit from having heard disastrous accounts of liability from less fortunate business colleagues, Al reaches a decision to incorporate Town Cleaners. Now he enjoys the limited liability protection of a shareholder in a corporation; Town Cleaners, Inc. is a separate legal entity from Al, and claims against the cleaners will not extend to Al to personally fulfill.

Now that Town Cleaners, Inc. has been added to the Smith's asset protection structure, their attorney advises them to reallocate ownership interests in the following manner:

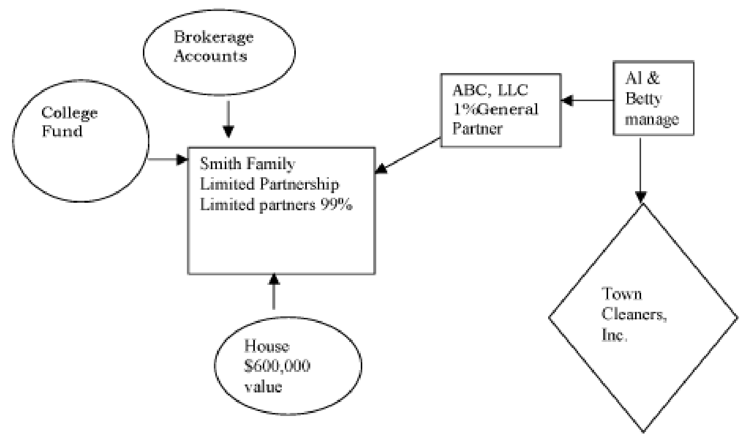

Figure 3

Al and Betty fully control ABC, LLC and Town Cleaners, Inc. through their own management company; ownership of the Smith Family Limited Partnership is allocated 1% to ABC, LLC (as general partner), and 99% to family members as Limited Partners.

This configuration shifts liability onto ABC, LLC as General Partner in the event of al awsuit against the Smiths, and provides a generally more complete protection structure.

Adding to our fictional account, perhaps Al and Betty have a vacation condo in Palm Springs that they also rent out to offset its cost. Knowing that the condo is a high-risk asset, Al and Betty form a limited liability company, PSC, LLC, to separate it from their assets in the Smith Family Limited Partnership. Should a renter sue them for an accident that occurs at the condo, and if damages exceed insurance coverage,they can only be paid from the assets held within PSC, LLC, which, in this case,amount to only the condo itself. They also want to avoid having the condo as a target for some other creditor not related to use of the condo. If there is substantial equity in the condo, Al and Betty may decide to have PSC, LLC further encumber the condo with a home equity loan, or have the Smith Family Partnership grant a second mortgage loan to PSC, LLC, which would limit equity available to potential creditors (this process is called "equity stripping"). Their asset protection structure looks like this:

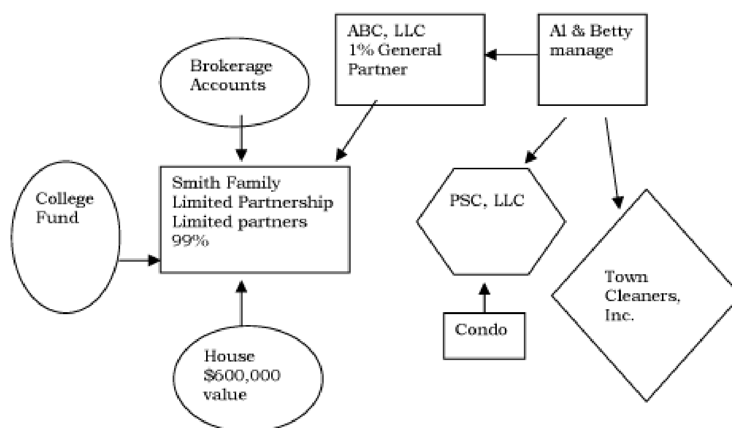

Figure 4

Al and Betty want to set aside a portion of their investments for their children's future benefit, yet still have control over buying, selling, or re-investing these interests while they are living. They are also concerned that their investments may be tied up in the probate process when they pass away, which would result in funds not being available for their children's use (if needed immediately) for some time. Ideally, Al and Betty would want to retain some interest income generated by the investments during their lives. They heard about living trusts, but were unsure about what type would serve their purposes. A domestic living revocable trust, which can be changed or revoked by the Grantor at anytime, is often used to keep assets out of the probate process, since ownership of the assets will pass directly to the named beneficiaries upon death. Al and Betty could set up such a trust, naming themselves as beneficiaries of the interest income, and their children as future beneficiaries of the principal. In most states, however, the retained power to receive interest income is reachable by creditors of Al and Betty, so it turns out that although a domestic living revocable trust would keep their assets out of probate when they pass away, it won't do much with respect to protecting their assets from creditors. What Al and Betty really need to deal with these multiple issues is a type of trust that protects the income that beneficiaries receive from the reach of their creditors. A spendthrift trust does just that, but is typically set up for the benefit of someone other than the Grantors. For the Grantors to receive this type of protection, they would need a "self-settled irrevocable trust with spendthrift provisions." Being irrevocable, the trust provides strict limitations on the power of the Grantors to change or revoke. The few states (such as Alaska and Delaware) that allow domestic self-settled irrevocable spendthrift trust protection to extend to the Grantors of the trust are confronted with a protection-stripping obstacle, the Full Faith and Credit clause of the U.S. Constitution.

What the Full Faith and Credit clause does is require states to enforce judgments from other states if the judgments are applicable to persons or property in those states. If a creditor obtains a judgment against Al and Betty in a state that does not permit self-settled irrevocable spendthrift trusts that favor the Grantor-Beneficiary, that judgment must be honored by the state in which Al and Betty created their trust. Have Al and Betty reached an impasse in asset protection? No, but they may have to look at offshore options to achieve the greater protection they want.

Offshore Structures

The concept of offshore asset protection is, well, foreign to many people's thinking.It's even considered unpatriotic to others. Nevertheless, the fact of the matter is,domestic asset planning structures may provide inadequate protection for certain assets and certain risks, as Al's and Betty's situation illustrates. It may very well be true that you will find domestic structures suitable for your particular needs, but it is in your best interest to explore all of the options available.

The offshore trust is a key component in many integrated asset protection plans.It presents unique legal and practical barriers to creditors; its most distinguishing legal characteristic is that it is protected by the laws of the foreign jurisdiction; generally,offshore courts do not recognize U.S. judgments. In a nutshell, creditors seeking to enforce a judgment against someone whose assets are held in an offshore trust (or its operating entities) must use the foreign court to hear their claims all over again. Of course, that depends on whether the court is first willing to do so, since foreign statutes of limitations may bar claims that are raised too late by creditors, or there may be laws that prohibit creditors' challenges to certain kinds of structures.

For example, Nevis, the Bahamas, and Cook Islands statutorily require that an action seeking damages to be paid from trust assets must be commenced within two years of the transfer of assets to the trust; later actions will be barred from recovery. In contrast, the Cayman Islands has a six-year limitation period for creditors' claims, and Belize and Turks and Caicos Islands do not state any limitations period. Many of these jurisdictions take the position that transfers that were made in the short-term (for example, within the past two years in Nevis) raise a suspicion that such transfers were made with specific creditors' actions in mind, thus creating a "fraudulent transfer." In that case, the local court may allow the creditor's claim. (In Nevis, for example, if the two-year statutory time frame had passed, there would be no basis for an attack using the legal argument of fraudulent transfer.)

The practical barriers that creditors face are numerous: creditors need to hire locally-admitted attorneys to represent them, and possibly post cash bonds prior to beginning a lawsuit; and the country might be very inconvenient and costly for the plaintiffs and their witnesses to travel to in support of the action. The very existence of an offshore trust in your protection plan places a significant obstacle in the path of your creditors and is, at the very least, a formidable deterrent against unwarranted creditors' attacks.

Getting back to Al and Betty, if they want to set up a spendthrift trust naming themselves as beneficiaries, they can do so offshore with a greater sense of security than in the U.S. It's their choice as to how much, and what type of protection they want.Here's how it works.

First, with their attorney's assistance, they discuss options and decide on a plan.They then process the trust documentation, and select a foreign trustee (usually, a licensed trust company) to manage what will be their trust corpus. They fund the corpus with various investments or ownership interests they have held up to an amount they consider prudent, and designate themselves and their children as beneficiaries of the interest income and principal, respectively.

The trustee is instructed to distribute the income according to Al's and Betty's wishes. As long as the transfer of assets is not deemed fraudulent (e.g., made intentionally to defraud legitimate creditors), if Al and Betty are sued, the trustee cannot distribute assets to the creditor because the creditor is in the U.S., raising a U.S.-based claim against a trust that is not in the U.S. If the trustee is sued, it cannot comply with an order to distribute assets because the trust instrument was drafted to contain an anti-duress provision preventing distributions made under duress (duress, in this case, would be defined as a demand from a court to turn over the assets in satisfaction of a creditor's judgment). Al and Betty will cease being beneficiaries until matters are resolved, and the trust will continue for the future benefit of the children. There are important reporting requirements to the IRS for this type of trust, but if it is drafted and operated to be "tax neutral" (meaning that income earned by the trust will still be assessed U.S. income taxes), it should not raise undue concern.

Say that Al and Betty want to tie their domestic asset protection structure together with an offshore trust to strengthen their defenses against creditors. What they can do is reconfigure the ownership percentages of the Smith Family Limited Partnership, allocating 99% ownership to an offshore trust as limited partner, retaining 1% interest in ABC, LLC as general partner. For a variety of practical reasons, this is typically done by letting the offshore trust maintain a "captive investment company" (essentially a management company) to hold its investment interests. Let's call that company Family Holdings, Ltd ("FHL"). The investments held by FHL may be in the U.S. or in offshore accounts. Assets do not have to remain offshore, and the trust can decide to open U.S. brokerage accounts through FHL.

If the economic or political environment was becoming unsettled, the assets could always be repatriated back offshore.

Depending on the asset, the trust (through its captive investment arm FHL) may control the S corporation, Town Cleaners, and the condo owner, PSC, LLC, either directly or through the family holding entity (Smith Family Partnership) to further remove Al and Betty from direct ownership and, consequently, direct attack from creditors. The asset protection structure now looks like this:

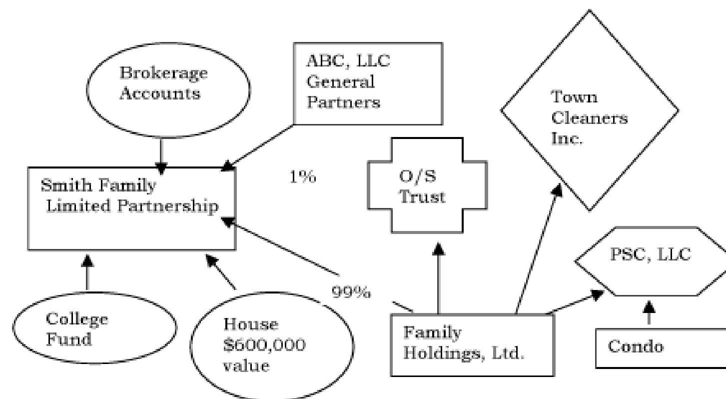

Figure 5

Adding a final piece to our fictional case about Al and Betty, assume that four years after Al and his partner split, the former partner claims that Al still owes him$300,000, representing his accounting of the appreciation of his capital investment, plus interest. Al disputes the claim, and his former partner threatens suit. Since Al has carefully planned in advance to protect his assets, the best that his former partner can hope for is some lower level settlement of his claim.

The illustrations presented in Al's and Betty's case show just a few of the various types of asset protection structures available both at home and abroad for individuals seeking the greatest defense against creditors' claims. Your particular needs will likely differ, and for that reason, it is advisable that you seek the counsel of an experienced asset protection attorney to help you create a plan of protections suitable to your needs.

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