

Keeping What You Have
An Overview of Asset Protection Planning

Frank Armstrong, III, CLU, CFP®, AIFA®



3250 Mary St., Suite 207
Coconut Grove, FL 33133
305 443 3339 / 800 508 3500
www.InvestorSolutions.com

Introduction

Are you sure you will never be sued? Are you sure that if you are, the courts will be fair? Are you willing to bet your entire financial future on it?

In 1994, over 800,000 lawyers filed over 14 million civil cases, an increase of over 25% during the preceding five years. Seven of ten adults will be sued during their life, some several times. While certain professions and occupations are at increased risk (See sidebar), random litigation is an equal opportunity disaster, where even middle class Americans are targeted. High profile, deep pocket defendants are eagerly pursued by greedy litigants. Liability insurance is a mixed blessing. While it does cover legitimate claims, it can also act as a lightning rod attracting frivolous litigation

Gun slinging attorneys view causing emotional stress, time loss, unwanted publicity, property loss, and financial ruin as just good clean fun. Liberal courts system often sees wealth as ill gotten, and will actively promote its redistribution as a cure for perceived social evils. Emotional jurors may focus more heavily on ability to pay than on actual responsibility. Judicial awards and punitive damages may be viewed as a handy tool to promote political causes. Costs of litigation are so high that even “winners” are often wiped out.

The potential costs of a lawsuit can be devastating. CNN recently reported that: “Millions of lawsuits are filed in the United States each year, at an estimated cost of about \$150 billion, or 2.5 percent of the Gross National Product. The

Groups with increased risk of litigation:

- A member of a high-risk profession: surgeon, ob-gyn, attorney, investment advisor, etc.
- You have had or may someday have a lapse in liability coverage.
- You have chosen not to carry or cannot afford liability or errors and omission coverage.
- You believe that high levels of liability coverage attract litigation.
- Your business requires you to assume general liability for ongoing projects: Building contractor, real estate developer, etc.
- You ever owned real estate that might have a toxic waste problem.
- You own assets that might trigger liability: Aircraft, boats, apartment buildings, other real estate or equipment for lease.
- You have sold or will sell an ongoing business.
- You had or have employees.
- You sit on a corporate, charitable or other board of directors.
- You are a general partner in any enterprise.
- You are a fiduciary for a pension plan.

chance of one of these lawsuits being directed at you grows each year. The mean compensatory award exceeds \$700,000 and has grown every year since 1991. About 40 percent of compensatory judgments exceed \$100,000 and more than 10 percent are above \$1 million.

These figures do not include punitive awards or legal fees.”

"The biggest misperception people have is that they aren't going to be sued or that a lawsuit won't have merit and will be settled for a small amount," Don Griffin, a director at the National Association of Independent Insurers, said. "But that's not typical in this day and age."

Fortunately, you can reduce your exposure. Lawsuits are avoided or settled if there is doubt about either liability, or collectability. Asset protection planning raises a series of defenses that makes collection problematic.

These defenses vary in complexity, cost and effectiveness. Even the most elementary might be enough to deter a frivolous lawsuit, while the most sophisticated defense may not discourage an irrational deep-pockets litigator. Let's look at some of the most basic defenses:

The social costs of this problem are huge. For instance, if an obstetrician that delivers 200 babies a year must pay \$200,000 a year for malpractice insurance, then each mother must count on an additional \$1,000 built in cost for pregnancy care. Worse yet, many physicians may refuse to treat difficult cases in an attempt to avoid litigation. Defensive medicine piles on unnecessary tests and procedures to build a record. An atmosphere of mutual distrust grows between patients and physicians. And we all get to pay for it in additional health insurance costs.

Is it any wonder then that increasing numbers of Americans are exploring perfectly legal and moral ways to reduce

their exposure? Unless you believe that you have an absolute obligation to make yourself the most attractive possible target to every crackpot litigant in town, you might want to consider prudent steps to lower your litigation profile.

Asset Protection Planning (APP) should be an integral part of financial/estate planning for every individual or family. In the last ten years, the field has become a recognized specialty in the practice of law. Properly accomplished, it can vastly reduce the threat to wealth that future creditors might pose.

The general objective is to retaining control and enjoyment of your property while erecting legal barriers to future creditors. By controlling in advance where and how litigation will be fought, and diminishing greatly the probability of a successful collection, much litigation can be avoided entirely or settled for reduced amounts.

APP is effective against future litigants or creditors. However, these steps are unlikely to be much help against pending, threatening, or expected litigation. In very general terms, any divestiture or transfer to avoid current creditors is most likely to be viewed as fraudulent and reversed. So, a key to successful planning is to act before a threat or cause of action arises.

Additionally, if after a transfer or divestiture, a person acts with wanton disregard for the rights of others, or if transfers left him less than solidly solvent, then those transfers are most likely subject to reversal. Asset protection planning is not a license to act irresponsibly, create a fraud, deliberately make oneself insolvent, or otherwise thumb your nose at the system.

Basic Asset Protection State and Federal Protections Insurance

Simple but effective protective measures

There are a number of steps that Americans can take to reduce their exposure, and to protect their property. As you might expect, these solutions vary in complexity, cost and effectiveness. Let's look at the most basic defenses, and protections built into existing law that you can take advantage of.

Federal Protections

Pension accounts are generally out of reach of creditors as a result of federal legislation (ERISA). However, if a corporation is closely held, the owner's account may in some cases be considered an asset of the corporation. Protection does not extend to IRS liens, court ordered divorce settlements or child support. Any distribution from a qualified plan is not covered by federal exemption.

State Exemptions

All states have statutory protection for some amount of some classes of property. The best we can do is give you a flavor for some of the exclusions that might be available to you in your state.

IRA Assets

Protection of IRA's is subject to individual state legislation. As a result, protection varies from zero to unlimited. Many states that do provide protection have expanded that protection to include Roth IRAs as well.

Homestead

Most states provide some form of protection for the primary residence. For instance, Florida exempts the homestead without limitation of value for ½ acre inside a city limit or 160 acres in an unincorporated area. But, California exempts only up to \$100,000 value.

Titling Provisions

You may be able to title property (not necessarily real estate) to make it more difficult under state law to attach, or make the property less desirable to the creditor.

Tenants in Common is a form of ownership where each owner holds a specified portion of an asset. Because these ownership interests are easily transferable, there is little creditor protection besides the inconvenience of owning an asset with others. Once ownership is transferred, it is often possible for a party to force division of the property.

Property may be held jointly with right of survivorship (JTWROS) or tenancy by the entirety. Few investors realize that there is a huge difference between the two. It would be unfortunate indeed for a debtor to learn the key differences during or after litigation.

JTWROS may offer a low level of asset protection, especially where assets may not be easily divided making the undivided interest less valuable to creditors. In some states, the joint

tenancy may be “severed” leaving the interest of the debtor subject to his creditor. Joint tenancies can often be invaded to the extent that a contribution is traceable, and if not traceable, may be entirely subject to creditors of either party. Creation of a joint interest may present gift tax complications where both the parties are not U.S. citizen spouses.

Where available on a state-by-state basis, tenancy by the entirety is reserved for married couples and may offer more complete protection against creditors of one party. But, the titling must be recorded exactly correctly to get the anticipated benefits. Beware: many banks and brokerage houses do not offer account registration as tenancy by the entirety.

Neither JTWRROS nor tenancy by the entirety is a complete asset protection solution. If both parties are found liable for a debt, it offers no protection at all. Worse yet, if the spouse or joint tenant takes off, the property may be lost, and the debtor worse off than if it had gone to the creditor. Or, if the “wrong” party dies, the debtor could lose the property immediately. Jointly titled property may be subject to liens that will make it impossible to dispose of. Finally, property held as JTWRROS or tenancy by the entirety may be an estate tax disaster in large estates.

Wages

Many states provide protection against garnishment of wages of various amounts and for various time periods after received. Where available, the terms of protection may vary as a result of factors such as whether the wage earner is the “head of household” or if the amount

covered is “reasonable” for the wage earner and his household.

Life Insurance and Annuities

The cash value and/or proceeds of a life insurance policy or annuity are protected by some (but certainly not all) states.

Common problems with statutory exemptions

Each of these elementary defenses is subject to problems and attack. State exclusions may not be adequate or may be reduced by the state later. They are always subject to reinterpretation by the state courts, and new “heroic legal theories” arise each day from the fertile minds of the varmint legal class. “Results oriented” judges can find a number of clever ways to get what they want done if property is within their reach.

Insurance

Of course, most of us rely on insurance to provide an asset protection shield. But, insurance may not be available, have gaps in coverage, contain exclusions, or may be cost prohibitive. Or, the award may exceed the limits of the policy.

Insurance companies maintain stables of their own expensive house attorneys busily engaged to find ways not to pay claims once incurred. This process is euphemistically referred to as “underwriting at point of claim.” The rationalizations and imagination of insurance companies vary directly with the size of a potential claim.

Or, the insurance company may go out of business, or withdraw from a state. The largest malpractice carrier in Ohio recently folded, leaving many physicians suddenly hung out to dry.

Insurance poses some difficult moral problems. As responsible citizens, we want to cover legitimate claims, but the presence of large amounts of insurance coverage may actually attract fraudulent or frivolous litigation. And, insurance companies often pay simply to make these bogus claims go away for nuisance value. Professionals and others often find their

reputations damaged where insurance companies force settlement rather than fight a spirited defense.

Conclusion:

While it would be foolish to ignore any available statutory exemptions, it's very unlikely that they could form the basis of a comprehensive asset protection plan.

Asset Protection Planning: The Family Limited Partnership

The hodge-podge of basic steps available to you under the various state and federal exemptions for asset protection planning may not give you great comfort. As previously observed, depending on the individual fact pattern, they can range from highly useful to totally useless.

Because no one can take from you what you used to own, a common thread through advanced asset protection techniques is to divest oneself of assets but retain control. A useful rule of thumb is that if it's not out of your control, it's not out of the reach of your creditors. The trick is to balance present enjoyment of the property with your need to protect it from future creditors.

Depending on your individual circumstances, the family limited partnership (FLP) may provide a higher level of protection at a reasonable cost while still allowing you flexibility to control and enjoy your assets.

What is a partnership?

Partnerships are separate legal entities under state law to enable unincorporated businesses to function. The law specifically recognizes the "personal" nature of the relationship between the partners. Accordingly, there are restrictions on the transferability of the partnership interests. A transferee has essentially no legal rights as a partner, and may not become a partner without the consent of the remaining partners.

What is a limited partnership?

Limited partnerships have two classes of owners. The General Partner (GP) is responsible for all aspects of the business and is liable for all obligations of the partnership. The Limited Partners (LPs) do not participate in the business decisions, may not force distributions, and have no financial responsibility beyond their equity interest. The LP owns a share of the enterprise, shares in the profits and losses of the business according to the provisions of the partnership agreement, and is entitled to receive distributions from the partnership **if and when declared**.

In 48 of the 50 states, limited partnerships are created under a uniform code. The most significant differences between the adopting states are the cost of registration and annual fees. Lacking any compelling legal advantages for selecting one state over another, many practitioners routinely recommend Nevada, the state with the current lowest fees.

Partnerships file an information tax return, but pay no income tax. Instead, taxes are passed on to partners under terms of the partnership agreement. Partnership accounting is not particularly difficult, and many consumer income tax programs include the necessary forms and instructions.

The family limited partnership

The limited partnership is a handy vehicle for asset protection planning. When formed between family members, a family limited partnership (FLP)

allows a person to divest himself of assets but enjoy a high level of control. Typically the donor retains a token GP interest in the partnership, and assigns the balance as LP interests to spouse, family, friends and charity. As GP the donor retains control over all the assets. As always, when transferring property, take care not to trigger an unintended gift tax problem if the recipient is other than a spouse.

This application of the FLP is intended to be tax neutral. Various past schemes to divide earned income among family members have universally failed, landing many participants in very hot water or jail.

Charging order protection

A creditor of a partner of a FLP is entitled to a charging order against the partnership interest as the “exclusive remedy for judgement”. The judgement creditor has only the rights of an assignee of the partnership interest. S/he can not become a partner, or take any part in the business of the partnership. S/he can only expect distributions if and when made, but worse still will be responsible for the taxes on the partnership gains and losses. This “phantom income” problem makes the partnership interest distinctly undesirable to any creditor. Because it is highly unlikely that the partnership will declare a distribution subject to hostile creditors, charging order protection becomes a waiting game with a tax headache attached.

Chinks in the armor

In theory, at least, the creditor slinks away at this point. While many creditors will fold, the FLP isn't bullet proof.

There are a number of weak points in this armor:

- If they have a variety of potential courts to bring action on a particular case, creditors are free to “shop” for favorable situs. The partners may not be able to control where the legal battle is fought.
- If the creditor is denied access to distributions, so are the partners. So, enjoyment of the property may be problematic. The partners may be unable to use the partnership assets for their support.
- The charging order may be so restrictive and onerous that business of the partnership comes to a screeching halt.
- If the partnership is found to lack a valid business purpose, the courts may dissolve it.
- A results oriented judge or a new heroic legal theory may dilute the expected protections. While the enabling statute may be uniform, interpretation by state courts is not. It is never a good idea to underestimate the power of an irritated state court judge. New points of attack can appear without notice.

Notwithstanding these potential flaws, a FLP can offer significant protection for your assets at a reasonable cost. Many potential creditors will be deterred, and much litigation can be avoided or settled early in the process under favorable or at least tolerable terms.

The Offshore Asset Protection Trust

No solution to the asset protection problem offers a total defense. But, the Offshore Asset Protection Trust comes closest. It has been referred to as the nuclear bomb shelter of asset protection.

What is a trust?

Unlike partnerships, trusts are not an entity. The concepts are inherent in common law. They are found, employed and well understood everywhere in former English colonies. There is no equivalent structure available in any countries with civil code.

Trusts date back to the Crusades where they were created by knights to preserve, protect and administer their property for the benefit of themselves and their family pending their safe return. Then as now, trusts provided both asset protection and estate planning benefits.

Trusts are a legal contract between you and a “trustee” to provide benefits to you and those you love. Trustees own property for the benefit of beneficiaries, establishing a severance of equity and ownership.

There are always three parties of a trust:

- Settlor - creates trust, donates property
- Trustee - holds legal title, administers the property
- Beneficiary - for whose benefit the trust is administered

The three parties are often the same. For instance, in a commonly used “living trust” the trust is created and managed by

a grantor as trustee for his own benefit. Some trusts also provide for a “protector”, a kind of super trustee with the right to overrule trustees. Where the settlor is also a beneficiary of the trust is often called a grantor trust.

Of course, trusts can have multiple settlors, trustees, and beneficiaries, and even different classes of each.

What is a foreign trust?

For our purposes, a foreign trust is one that has at least one foreign trustee, and at least some of the aspects of its operation are governed by non-US jurisdiction. In this context, a foreign trust is often taxed like any other US trust rather than a foreign trust. The trust can own property anywhere, so it could, for instance, hold title to your existing mutual funds, eTrade or TD Ameritrade accounts.

The foreign trust does **not** contain any tax advantages for US citizens. As designed, they are tax neutral, neither generating nor saving any additional taxes.

Why not a domestic trust?

Over time the original protections built into trusts have been watered down by statute and public policy provisions in many countries. For instance, the Statute of Elizabeth (1571) established a concept of fraudulent transfers, rules against perpetuities were enacted, and prohibitions against spendthrift provisions for grantor trusts were developed.

Many countries by treaty recognize judgements of other countries and extend

the “full faith and credit” to such foreign country’s judgements. This principle also referred to as “comity” is incorporated into the US constitution between our states.

Domestic trusts are routinely invaded by state and federal courts under a variety of conditions. They offer little in the way of reliable asset protection. At least two states, Alaska and Delaware have recently enacted some provisions that are designed to be more favorable for grantor trusts. However, there are many unresolved issues and little in the way of experience. It’s also reasonably clear that such trusts are subject to IRS and other Federal claims. So, most practitioners are taking a wait and see attitude or counseling avoidance.

In order to obtain the original asset protection benefits of trusts, it is necessary to base the trust in a country that has repudiated these provisions. Specifically, at a very minimum, we want a common law country that does not recognize foreign judgements, has repudiated the Statute of Elizabeth, has a reasonably short statute of limitations on fraudulent transfers, allows spendthrift provisions for grantor trusts, and has enacted other statutes that are debtor friendly.

Of course, we also need a stable government, a reputation for confidentiality and integrity, modern infrastructure and communications facilities, and sufficient professionals to administer the trusts. Fortunately, several island nations are busily competing for the offshore asset protection business and have adopted their laws accordingly.

It’s also clear that the foreign trustee should have no US business presence that would subject them to either direct or indirect control by any US courts.

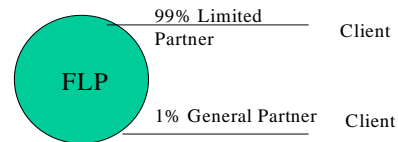
A sample case

As part of his overall financial and estate planning, Charlie Client wishes to set up a reasonable asset protection plan to shield himself and his family from future frivolous litigation. Charlie considers himself a responsible citizen, but he does not entirely trust the US legal system. He feels no moral obligation to arrange his affairs to provide maximum possible exposure to future potential litigants.

On the advice of his attorney he first registers a limited partnership in Nevada. He temporarily retains both a 1% general partner interest and a 99% limited partner interest.

Step 1

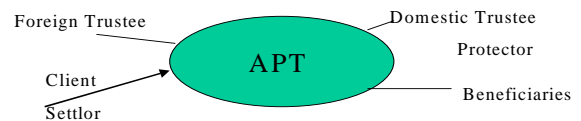
- Create Family Limited Partnership
- Create Limited Liability Corp for “Hot Assets”



Next, Charlie forms an offshore asset protection trust in the Cook Islands.

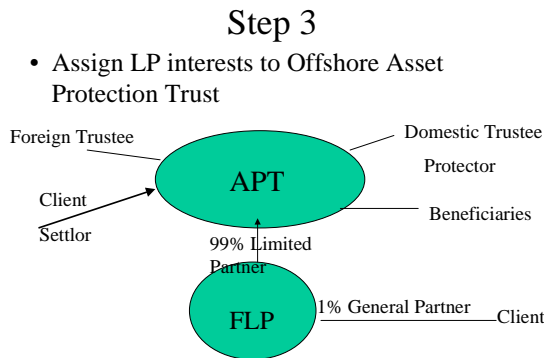
Step 2

- Create Offshore Asset Protection Trust



Charlie is the domestic trustee, the trust protector as well as the settlor and a beneficiary. His wife, children, grandchildren, and a charity are also beneficiaries. A company in the Cook Islands is designated the Foreign Trustee.

Charlie assigns the 99% limited partnership interest to the Trust.



Next Charlie funds the limited partnership and trust with appropriate assets, careful to leave himself solvent after divesting the majority of his assets. Funding is a simple matter of re-titling his assets to the new structure.

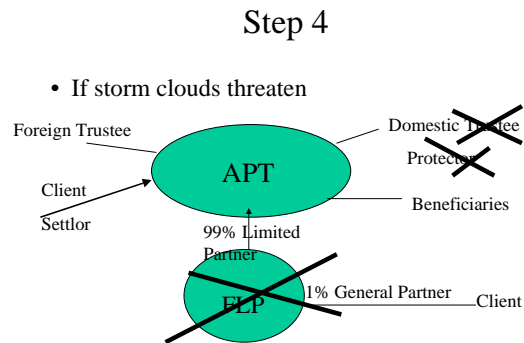
As GP, Protector and domestic trustee, Charlie continues to direct the investments and enjoy the benefits of the property. Charlie's taxes remain the same, although he now finds himself signing a couple of new forms for the partnership and trust.

Litigation rears its ugly head

One fine day several years later, storm clouds begin to form on Charlie's horizon. Litigation looms its ugly head. Charlie resigns as protector and domestic trustee. The foreign trustee dissolves the limited partnership and takes title to its property.

The assets in Charlie's eTrade account are transferred to a foreign custodian such as a Swiss bank outside of the control of any US Court. Under these emergency conditions, the foreign trustee now manages the property and takes care of Charlie and his family as the trust document dictates.

If litigation results in a judgement against Charlie, the judgement is not recognized in the Cook Islands, and the trustee will ignore it. Should the judgement creditor fly to the Cook Islands to pursue litigation, he most likely will find that every attorney on the island has a conflict of interest. He must fly off to New Zealand in search of an attorney able to practice in the Cook Islands. That attorney demands payment in advance because there are no contingency fees allowed there. The creditor's sole potential cause of action is limited to the question of fraudulent transfer, and the statute of limitations has passed on any transfers. Just to be sure, the trustee exercises the trust's flee provisions to re-domicile the trust in the Cayman Islands.



Should any US court require Charlie to request assets from the trust, the trustee refuses Charlie's request under the trust's duress provisions. Charlie has done everything required of him by the local courts, but simply does not have the

power to comply. No contempt action against Charlie is possible.

Epilogue

Faced with all these daunting problems, the creditor offers to settle on reasonable and tolerable terms. Charlie accepts and lives happily ever after. Because Charlie planned in advance, he was able to dictate where and under what law the final legal battle would be fought. Charlie's foresight preserved his accumulated wealth for him and his family and bought him peace of mind.

Links to additional information:

These internationally regarded firms each have posted an extensive library of general interest previously published papers. Combined, these papers should provide

you with an excellent introduction to the issues and possibilities of asset protection planning.

Howard Rosen, Esq.
Donlevy-Rosen and Rosen, PA
133 Sevilla Ave
Coral Gables, FL 33134
305.447.0061/Fax 305.444.3683
www.protectyou.com

Barry Engel, Esq.
Engel, Reiman & Lockwood, PC
The Quadrant
5445 DTC Parkway, Suite 1025
Englewood, CO 80111
303.741.1111/Fax 303.694.4028
www.erl-law.com

(Note: Both the Offshore Asset Protection Trust and the FLP are widely used highly useful estate planning devices, but that application is beyond the scope of this article.)

Disclaimer: The author is the principal in a registered investment advisor firm. We are neither attorneys nor accountants, and do not attempt to practice either profession. The preceding information is for general educational purposes only. Because high net worth investors often have complex asset protection, tax, and estate planning needs, they should seek competent counsel.