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Protecting your assets . . . before it's too late

Planning ahead with a trust or family partnership, could keep you from financial ruin

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The average physician will be sued several times during his or her career and therefore faces the possibility of suffering a ruinous judgment. Failure to plan for that can result in instant loss of a lifetime's accumulated wealth.

Consider the following:
As a defendant, you are at a considerable psychological disadvantage. Good plaintiff's lawyers know how to exploit this weakness. As the accused, you may have the full weight of the American legal system brought to bear against you to vindicate the rights of the plaintiff. Those rights are broad and always expanding.

Since you are an affluent defendant you will not be judged by a jury of your peers. The typical jury is not composed of physicians, entrepreneurs and millionaires. The jurors may bring all of their prejudices and resentment to bear when evaluating the facts presented against you. This effect is doubled if they can identify with the plaintiff—and the odds are greater that the plaintiff will be more like the jurors than you.

If your insurance company is your codefendant, you can rest assured the jurors will have even less compunction about spending the insurance company's money than they have about spending yours.

On this tilted-playing field, your only be a sound asset protection plan. But it will only work if you put it in place before you are sued.

Although a family limited partnership offers many benefits, it can limit your asset-protection options. Combining this strategy with a foreign trust can result in excellent creditor protection and flexibility.

Protecting your assets generally entails transferring them to someone else. That someone else may be an actual person or it may be a trust. Trusts may be based domestically or overseas. How much protection you will enjoy depends in large part on how and where these trusts are established.

What asset protection is not

Before you begin, it is important to realize what asset-protection planning does and does not include.

- It is not based on hiding assets. Hiding assets can be dangerous: It could put you in the position of choosing between protecting assets and committing perjury. Whether you are ever embroiled in litigation, you may face some difficult decisions each year when you file your income tax return. Full disclosure on a tax return is inconsistent with planning based on secreting assets. While you may appreciate the confidentiality that can be obtained through an asset-protection plan, a properly devised plan will not rely on secrecy to be successful.

- It is not an excuse to defraud creditors. But, given individual circumstances, there can be uncertainty as to when asset-protection planning can be implemented, and the extent to which it can be implemented at a given point in time. The "white" cases are easy to identify: They involve individuals with neither pending nor threatened claims. The "black" cases are also easy to identify: They involve individuals who are on the brink of bankruptcy (although prebankruptcy planning may offer some hope for such a person). In between are the many shades of gray. All states have outlawed the practice of selling or otherwise disposing of assets to avoid paying creditors. These statutes are known as fraudulent conveyance laws. Federal law may also apply in some situations. An asset-protection plan must be implemented within the bounds of propriety as defined by reference to applicable fraudulent conveyance law.

- It is not an excuse for evading taxes. Some clients are attracted to asset-protection planning by a tax advantage they hope to find. A well-designed asset-protection plan will have no particular income, gift, excise or estate tax disadvantages, either domestically or abroad. Tax neutrality will, therefore, prevail for the proper plan.

Advantages of trusts

A trust is a vehicle by which legal and beneficial title are severed, with the trustee receiving legal title to the property settled in trust, which property is to be held for the benefit of trust beneficiaries, who receive beneficial title. A domestic trust is settled by a person living in the United States and governed by state law. Foreign trusts are settled elsewhere and are governed by the laws of those countries. Choice of law principles allow a settlor who resides in one state to settle a trust to be governed by the laws of another country, just as a business owner who resides in and operates a business in Illinois may incorporate the business in Delaware. In the asset-protection planning context, domestic trusts suffer from a number of disadvantages when compared to foreign trusts:

- Domestic trust law will generally restrict the nature and extent of benefit and/or control that a settlor can retain through a trust. Domestic law generally provides that if a settlor does not place property out of their own reach, the trust assets will not be placed out of the reach of their creditors, whether present, subsequent or future potential.

Thus, a domestic trust that is settled at a time when there are absolutely no fraudulent conveyance issues may still be successfully attacked, even years after settlement, if the settlor has retained either benefit or control.

By comparison, the level of both benefit and control over a foreign trust governed by the trust laws of certain foreign jurisdictions will represent a significant enhancement over the rights and powers that may safely be retained by grantors of domestic trusts. Properly drafted, an asset protection trust may result in little diminution of such attributes.

- A domestic trust may be as much a target for litigation as its settlor, particularly if the trust holds assets of substantial value. A plaintiff's lawyer need not be particularly creative in order to craft a legal theory of liability against a domestic trust when the principal claim is against the settlor. Due to jurisdictional and other considerations, such as comity—that is, the judgments and orders of the domestic court being recognized by the foreign court—a foreign trust will not be such an "automatic" defendant.

• One of the advantages of foreign trusts over domestic trusts is that the foreign element will affect how far the creditor is willing to go in pursuing trust assets. Whether one considers the psychological barrier of dealing with foreigners and foreign systems, the cost of pursuing litigation overseas (particularly if the matter must be litigated anew in the foreign jurisdiction in the absence of comity), the added uncertainty of prevailing, or the increased time factor that results the practical hurdles obtained through the use of foreign entities can prove to be formidable barriers.

• The trust law of some foreign jurisdictions is simply more protective than domestic trust law. In fact, the past few years have witnessed a number of off-shore financial centers passing legislation designed to lend clarity to many trust issues, thus providing a substantial degree of certainty to a rapidly developing planning area. The leader in clarifying legislation is the Cook Islands, an offshore financial center located in the South Pacific. Its International Trusts Amendment Act of 1989 addressed not only fraudulent-conveyance issues, but also those relating to retained control and benefit.

Family limited partnerships

Family limited partnerships have become a popular tool for protecting accumulated wealth. Assets that would otherwise be attractive to a creditor are rendered unattractive by transferring them to a family partnership in exchange for general and limited interests in the trust. Most state partnership laws provide that a creditor's remedy against a limited partnership is to obtain a "charging order," which is typically a rather limited remedy.

Family partnerships are useful not only in rendering attractive assets unattractive, but also in separating ownership from control. Even though substantial value can be gifted through transfers (either outright or in trust) of a limited partner's interest, control over partnership assets as well as possession thereof can be retained by the client who retains the general partner's interest.

As useful as such partnerships may be they are not the panacea some believe them to be. They have a number of disadvantages:

• The client remains subject to the whims of the domestic system of limiting planning to domestic tools. Family partnerships are most useful when the limited-partnership interests are gifted to a foreign situs asset-protection trust.

• A client will be limited in his ability to freely access partnership assets if a charging order has been obtained by a creditor.

• Concern exists that a principal purpose for the creation and funding of a partnership other than protecting assets may be imposed by a court, and thus the charging order may not be the sole remedy of the creditor.

• Independent of the "principal purpose" concern is the issue of whether the charging order is in fact a creditor's "sole remedy." A recent California case, *Centurion Corp. v. Crocker National Bank,* held that a judgment creditor was not limited to obtaining a charging order and was in fact able to attach and sell a limited partner's interest. Although the facts of this case are relatively narrow, it can certainly serve as a precedent for another court's adverse decision in the future.

Thus, although a family limited partnership offers a number of asset-protection planning benefits, a person of means who limits his or her planning to this approach will be compromising both the degree of protection and the number of options that otherwise would be available if a legal

problem were to develop. Combining a family limited partnership with a foreign trust can result in excellent creditor protection and flexibility.

A combined strategy

If you wish to retain control over the trust's assets and be a beneficiary of the trust, it is absolutely necessary to use a foreign trust. A foreign trust created under the laws of the right jurisdiction will allow the settlor to retain control and enjoyment of property. The U.S. rule voiding a trust created by the settlor for the settlor's own benefit will not be applicable overseas. U.S. laws will not be applied and the judgment and orders of U.S. courts will not be enforced as to these issues. Rather, more favorable local law will be applied.

In the view of the lawmakers of these foreign jurisdictions, a settlor may freely transfer assets to a family trust of which he or she is a beneficiary. The transferred assets will be excluded from the estate for purposes of future creditor attachment.

It is not necessary to part with control over transferred property. Such property need not be shipped to a foreign trustee, who may or may not be trustworthy. The property to be protected may be transferred to a domestic limited partnership. The transferor receives, in exchange for the contribution, a 99% interest as a limited partner and a 1% interest as general partner. The transferor then immediately transfers the 99% limited partner's interest to a foreign trust which is substituted in his or her place. As a general partner, the transferor controls 100% of the assets while owning only a 1% interest. The transferor has parted with ownership of 99% of his or her previous interest in the transferred assets.

The foreign trustees do not directly control assets; rather, they hold a passive interest in the limited partnership. In the event the pressure from future creditors eventually becomes so severe that the client fears the structure will be attacked in the courts of the United States, the assets held at the limited-partnership level may be transferred to an offshore entity that is the functional equivalent of the limited partnership and over which the client exercises a similar level of control.

Assets need not be held in the jurisdiction of the trust's domicile. They may be held in any major international financial center, such as London, Zurich or Singapore. The client therefore retains a psychological advantage against the plaintiff's lawyer, who cannot exploit the client's fear of loss of his or her property.

This is far less burdensome than it sounds. With instant communications and international banking facilities, it is as convenient to hold accounts and assets overseas in another city in the United States. For example, major international banks offer checking accounts and time deposits in U.S.-dollar-denominated accounts that typically offer better interest rates than domestic banks. The foreign trustee may pay the client's mortgage and other bills directly. There is thus no disruption in the client's standard of living. Once the case is settled, assets held abroad may be returned to the United States if the client so wishes.

The trust/limited-partnership structure is tax-neutral. The income of the partnership will flow to the trust, which is a grantor trust for federal income tax purposes—that is, the trust's income is taxed to the settlor as if the settlor continued to own the property free of trust. If it is properly structured as a discretionary trust, transfers to it will be deemed incomplete gifts for federal gift tax purposes. Because the settlor retains certain powers over the trust, the trust's property will be included in the settlor's estate for federal estate tax purposes.

The foreign-trust approach described above is also applicable to qualified retirement plans. Such plans are also trusts, and they may be amended to provide that assets may be held offshore in the custody of an offshore trustee.

Although plan interests are exempt from attachment under the laws of most states, this is often not the case in federal bankruptcy court. There has been a disturbing trend in bankruptcy courts to recognize certain theories that allow for the plan interests of controlling shareholders to be subject to creditor reach in certain cases. Federal law in this area remains unsettled, and it is best to plan for the worst while hoping for the best.

Practical applications

Although the free-floating anxiety that affluent clients feel with respect to potentially ruinous litigation is reason enough for them to consider this form of asset-protection planning, a number of specific advantages also suggest consideration of these techniques.

- Asset-protection planning serves as a supplement to existing liability insurance.
- It allows a fresh start outside of bankruptcy by allowing the creation of a separate entity through which future business may be conducted.
- The properly drafted offshore trust is a suitable substitute for a prenuptial agreement, and is free from the uncertainty that gives rise to questions about the ultimate enforceability of such agreements.
- To avoid the potential for a total loss of all assets from one failed project, or from a successful project with a latent defect, a nest egg can be segregated into an offshore trust.

Protect yourself now

A foreign trust created under the laws of the right jurisdiction will allow you to retain control and enjoyment of your property. The time to protect yourself is now, before crippling litigation or judgments bar you from making transfers of property that may be considered fraudulent.

For additional information call Robert D. Gillen, Esq. at 630-420-7300