Asset Protection: Reducing Risk, Promoting Peace of Mind

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Every American adult shares a dubious characteristic—each is a walking litigation target. Part of your birthright is that you may be sued at any time, for any reason, and for any amount.

Civil actions range from the serious to the frivolous. Did you offend someone today with something you said? Did you cause someone to suffer sudden whiplash syndrome in the parking lot? Are you a professional facing a disgruntled client or patient? Do you own a company employing someone who did something irresponsible on company time? Did you err on the side of caution… or throw caution to the wind?

Each choice you make might be construed as "actionable." That is, someone might spin a good case—or at least a good story—about how you crossed a line in some way, and why you should now pay dearly for your failing.

Sadly enough, the more money you have the more tempting a litigation target you are. And you are an even riper target if you value privacy in your affairs. The "discovery" phase of litigation will put an end to your uncivil habit of protecting personal information.

WHAT CAN BE DONE?

Well, you could hope for a sudden triumph of common sense in the land. You could hope that plaintiffs with ridiculous claims will suddenly feel shame and go skulking into obscurity. You could hope Congress will start returning cash donations from trial attorneys and embark on a frenzy of tort reform. Or you can seize the opportunity to control that part of the equation you actually can control, and build a protective barrier around your family and business assets.

Yes, there are proven strategies that will ethically preserve your wealth and keep the vultures at bay. Your most powerful weapons in this fight will be a variety of estate planning tools, including the Family Limited Partnership, the Irrevocable Life Insurance Trust, the Children's Trust, and Foreign Asset Protection Trusts.

THE CHILDREN'S TRUST

One way to place asset beyond the reach of potential plaintiffs is to transfer property to your children.

Like most parents, you've probably been acquiring an estate not only for your benefit while you are alive but also to help your children and grandchildren. The IRS will allow you to give up to $15,000 per person per year absolutely free of gift tax. If both spouses join in the gift, you can give up to $30,000 per person a year, gift tax-free. (As indexed for inflation.)

By giving property to a Children's Trust each year, you can shift the income from your high tax bracket to the lower tax bracket of your children or grandchildren who are age 23 and older.

Unfortunately, children under age 23 must pay most of their taxes at the same rate as their parents (between ages 18 and 23, children may qualify to use their own rates depending on the circumstances).

Once the Children's Trust is sufficiently funded, it can pay the cost of a child's education. That way the expenses are paid with discounted tax dollars. (However, remember that parents or grandparents can pay tuition costs directly as a tax-free gift.)

If you own a business, you can gift its equipment and furniture to the Children's Trust and have the trust lease it back to the business. Under this plan, the business gets a legitimate tax deduction, and the rental income is earned by the trust potentially at lower tax rates. Plus, the benefit of the depreciation is given to the trust.

Having a Children's Trust or a Family Limited Partnership also promotes family investment values. The children now have an identifiable stake in the family's financial success. It goes a long way toward helping them understand the value of money and wise investments.

How does the Children's Trust protect assets? Well, all assets transferred to the trust are no longer in your name or owned by you, and are, therefore, outside the reach of plaintiffs or creditors, whether yours or your children's. However, you can't transfer assets when you have pending claims or lawsuits against you. Transfers at that time will violate something called the fraudulent transfer law. This will allow the courts to ignore the gifts to the trust and permit your creditors to seize them.

The Children's Trust also has probate avoidance and estate tax reduction benefits. All assets transferred to the trust are no longer a part of your estate. That means when you die, those assets will not go through probate and they will not be subject to federal estate tax.

If a couple had three children and gave each of them $30,000 in trust per year for 10 years, that would amount to $900,000 of tax-free gifts to their trust. At death, none of that $900,000 would be subject to federal estate tax.

Before creating a Children's Trust as part of an asset protection program, ask yourself whether you can permanently do without the benefits of the property. Once title is transferred into the trust, there is no going back. This trust can't be revoked or amended, so only transfer the assets that won't be needed by you to meet your personal expenses.

THE IRREVOCABLE LIFE INSURANCE TRUST

You probably already know several reasons why life insurance is important. Young families need it to replace part of a breadwinner's income. Mature Americans find it provides their heirs with a source of funds to pay estate taxes.

Life insurance can do all this and shield assets from litigation at the same time. How? By use of the Irrevocable Life Insurance Trust (ILIT). An ILIT is a good idea even if you don't worry about suits or creditors, because it allows the full value of your life insurance to pass tax-free to heirs. Without an ILIT, the government will count the face value of an insurance policy in calculating your taxable estate. Anything over the estate tax exclusion is subject to "death tax" at a 40% rate.

When you set up your ILIT, you name a trustee other than yourself, most likely a beneficiary. The trustee purchases a life insurance contract on your life with funds you provide. If you have an existing policy, you can assign ownership of it to the ILIT, but there are conditions imposed on these transactions that should be carefully considered before you do so. For instance, if you die within three years of the transfer, the life insurance contract will be included in your estate.

As we saw in the case of the Children's Trust, a taxpayer may give up to $15,000 (indexed for inflation) annually to another person free of gift taxes. Other than the per-person rule, there's no limit on the total amount you can give away. For example, if you have five children and eight grandchildren, you and your spouse could give each one $30,000, for a total of $390,000 annually, gift tax-free. That can buy a lot of life insurance. By carefully following the IRS rules, you can employ this gift tax exemption to make the policy's premium payments.

Reducing your estate tax liability is a powerful incentive for considering the ILIT. But that's just the beginning of the long list of benefits it provides.

The ILIT gives you control over how proceeds from your life insurance policy are spent. You control who receives the proceeds and how they receive them. Whatever distribution strategy makes most sense for you and your loved ones, the ILIT gives you the opportunity to put it in effect.

And, of course, there's its important asset protection benefit. Over the years, your premiums and interest earnings can accumulate to considerable sums, making cash value policies a tantalizing target for creditors. When the policy is owned by the ILIT, however, it is out of the reach of creditors.

FAMILY LIMITED PARTNERSHIP

A Family Limited Partnership (FLP) is one of the most popular estate tax and asset protection planning devices. An FLP is simply a limited partnership similar to the real estate or business operating limited partnerships with which many are familiar. When you transfer your business and investment assets into an FLP, you receive in return:

General Partnership Interest: Generally, you receive just 2% of the total partnership interests in the form of general partnership interests. That means that you control all of the decision-making for the FLP's activities.

Limited Partnership Interest: You receive the remaining 98% of the FLP in the form of limited partnership interests. Limited partnership interests give the limited partner very limited rights in partnership income and activities. While general partners may not treat a limited partner unfairly, a limited partner essentially has no meaningful control or rights.

You are now the proud owner of your very own FLP. You are the 2% general partners and control the partnership. Now what happens? You will give your children some of your limited partnership interests. That means that the partnership has partners other than just you.

As a general partner, you have complete control and access to the assets and income of the FLP in accordance with terms you designed. If you have given your children 10% of the FLP, they are entitled to 10% of any distributions that you decide to make, but they cannot force you to make any distributions.

Note: If estate tax reduction is one of the other purposes of the FLP, additional restrictions may be required.

HOW DOES THE ASSET PROTECTION BENEFIT WORK?

If you are successfully sued, all the plaintiff is able to receive is a "charging order." That's a judgment against the partner that tells the partnership that any distributions of profit that would otherwise be made to the debtor partner must instead be paid to the plaintiff/creditor. But the plaintiff has no power to interfere in partnership matters.

The charging order is a very hollow victory. Because the general partners decide if profit is to be distributed to the partners, the general partners can withhold distributions for partnership purposes and the creditor receives nothing.

Obviously, the creditor does not just go away, but because the charging order provides so little leverage, creditors frequently settle the claim for less than face value. Those who might consider filing an unjustified lawsuit may change their minds when they realize that all they will receive is a hollow charging order.

FOREIGN ASSET PROTECTION TRUST

The ultimate asset protection tool is a Foreign Asset Protection Trust.

What is a Foreign Trust? In many ways a Foreign Trust looks exactly like a Domestic Trust. The trustor is you, the person who transfers the assets to the trust. The trustee is a trust company, experienced in asset management, whose business is operated outside of the United States in a jurisdiction that does not recognize United States judgments.

In a typical trust, the trustee is given discretion to accumulate or distribute trust income among a specified class of beneficiaries. You may be one of the named beneficiaries, together with your spouse, children, or grandchildren.

One unique feature of this kind of trust is the role of the "Protector." The trust protector is a person who has the power to take virtually any actions necessary to protect your trust. The term of the trust may be limited to a period of years. You can often specify that the trust will last for a term of 10 years with several optional renewal periods.

One way to use a Foreign Trust is to set it up and then transfer your cash, securities and other liquid portable assets to an account established under the name of the trust at a bank of your choice in a foreign jurisdiction.

We've found that many people are reluctant to transfer their assets out of the country or give up the day-to-day control of their investments unless it's absolutely necessary. To solve these concerns, planners combine the best elements of the Foreign Trust with the management and control of the limited partnership. Under this arrangement, you and your spouse are the general partners with total management and control over the partnership assets. But instead of you and your spouse holding a limited partnership share, you transfer that interest to a trust in a favorable foreign jurisdiction.

As the holder of the limited partnership interest, the foreign trustee has no right to interfere with management of the partnership. You alone manage your finances. Even though the trustee holds the limited partnership certificate, the assets themselves are physically located in the United States. This set-up provides maximum flexibility and sound lawsuit protection.

One of the most appealing features of a Foreign Asset Protection Trust is that it produces absolutely no income tax benefits. Under current tax law, the trust is simply ignored for tax purposes. Like the Living Trust, all of the income is reported and tax is paid on your personal income tax return. The reason this is attractive is that it allows you to create your foreign trust without interference or objection by the IRS. Because it doesn't affect your income tax liability, the government really pays little attention to these trusts.

We've seen that the Foreign Asset Protection Trust is easy to set up and there are little or no tax consequences. We've also seen that when the Foreign Asset Protection Trust is combined with a domestic limited partnership, you retain complete management and control over your finances.

So what role does the Foreign Trust play and why is it touted to be the ultimate in creditor protection? The simple answer is that U.S. courts and judges have no jurisdiction over the foreign trustee and the limited partnership interest.

Let's say a judgment has been handed down against you. Your first move would be to liquidate the limited partnership and make a distribution of each partner's share. The Foreign Trustee would receive the vast majority of partnership assets, and these would now be held offshore.

Obviously, if your creditor wants to get his hands on the property, he will have to travel to the foreign jurisdiction and ask the local court to enforce his U.S. judgment. Whether he wins or loses in the foreign court depends on the laws of the jurisdiction you chose as the home of your trust.

That's why selecting the proper jurisdiction for your Foreign Trust is a matter of critical importance. You should consider the following factors:

- Communicating with the trustee must be very convenient.
- Look for a well-developed telephone system and for a country that conducts its business affairs in English.
- Look for an area with a long tradition of trust law and for experienced trustees who understand their role in asset protection planning.
- Find a country that does not tax income earned by your trust.
- Your jurisdiction should impose harsh penalties on anyone who discloses confidential trust and banking information.
- The country should make it very difficult for a creditor to file suit against your trust and should not recognize or enforce U.S. judgments.
- There should be no restrictions on your right to move currency or assets in or out of the country and, finally, the jurisdiction should have a stable government built on sound English and American legal principles.

Here's a list of some of the more popular jurisdictions for your asset protection trust that have all of the important features we mentioned. The first four, the Bahamas, Bermuda, Barbados and

the Cayman Islands, are located right offshore and are easily reachable by air. They have long been known for their international banking and asset protection activities.

The Cook Islands are a group of islands in the South Pacific. Between 1901 and 1965, they were part of New Zealand. In 1965, they became independent and self-governing under their own constitution. The Cook Islands have no income tax and have been developing in recent years into the jurisdiction of choice for asset protection planning.

ABOUT THE ACADEMY

This report reflects the opinion of the American Academy of Estate Planning Attorneys. It is based on our understanding of national trends and procedures, and is intended only as a simple overview of the basic estate planning issues. We recommend you do not base your own estate planning on the contents of this Academy Report alone. Review your estate planning goals with a qualified estate planning attorney.

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