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Asset Protection and Retention of Control: Is Peaceful Co-Existence Possible?

Howard D. Rosen

ASSET PROTECTION AND RETENTION OF CONTROL: IS PEACEFUL CO-EXISTENCE POSSIBLE?

by Howard D. Rosen[1]

I. INTRODUCTION

Traditional thinking has held that protecting your assets from future creditors while continuing to control and enjoy the income from those assets are mutually exclusive goals. In his article, attorney Howard D. Rosen explains how the combined use of established business and estate planning techniques can permit realization of both goals.

Today we live in a society where litigation has become a popular tool for the accumulation of wealth, not only for money hungry plaintiffs, but for their ambitious lawyers as well. The explosion of all types of liability claims and new theories of liability, coupled with ever-increasing insurance premiums and defense costs, have stunned the business and professional community in Florida.

As an example, consider the case of *Tallahassee Furniture Company*,[2] where the court awarded $2.5 million to a woman who was stabbed by the company's delivery man. The company had

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[2] Harrison v. Tallahassee Furniture Co., Inc., 529 So. 2d 790 (Fla. Dist. Ct. App. 1988).

failed to interview the man, or to have him fill out an employment application (after all, he was not being hired as the company president). The case did not make new law, but it did illustrate, once again, the ever-increasing risk of conducting business, and the propensity for enormous jury awards being upheld by Florida appellate courts. Jury awards are being granted under old *and new* theories of liability, to the point where many businesses simply cannot afford to continue.[3] This type of loss has a "ripple" effect, resulting in increased insurance costs (if the company is fortunate enough to have coverage with a solvent insurer), which are eventually passed along to the public in the form of higher prices for goods and services.[4] Moreover, if punitive damages are awarded, even a solvent insurance company will not help, as punitive damages are not generally covered by insurance.[5]

What is left for the businessperson or professional who would like to continue in business or practice his or her profession and be able to sleep at night without fear of a financial catastrophe? What can the wealthy individual, seeking a bullet-proof pre-nuptial arrangement do? What is left for the retiring professional faced with staggering insurance premiums, providing, in many cases, totally inadequate coverage?

Seeking to protect oneself from potential creditors is nothing new. Traditional methods have typically involved outright transfers to a spouse or other family members, creation of irrevocable trusts, and secret "asset return" arrangements. The effectiveness of these methods in protecting assets is doubtful, and the use of each creates its own set of problems. These problems include fraudulent conveyance issues, exposure of the property to the transferee's creditors, gift tax issues, and most importantly, loss of income and control. A properly structured domestic trust may solve some of these problems, but where the client transferor retains "strings" over

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3 *See, e.g.*, Marcia Chambers, *Whatever Happened to The Sandlot?*, NAT'L L.J., April 22, 1992, at 15.

4 *Id. at 15-16.*

5 Tamar Lewin, *Business and the Law; Punitive Costs: Insurance Issue*, N.Y. TIMES, December 11, 1984, at D2.

the transferred property, the asset protection is nullified.[6] Those who wish to use a *domestic trust* to protect their assets *must sever all ties* to the trust, and be prepared to accept the resulting loss of income and control, and to address the resulting gift tax issues. None of the traditional methods mentioned seem to provide a solution to the asset protection dilemma. What is the answer?

The answer is: *Adopt advance planning strategies which place assets beyond the reach of potential future creditors.* By utilizing sophisticated estate and business planning techniques, none of which are new, a businessperson, professional, entrepreneur, or other target individual can effectively protect his or her assets from future creditors and at the same time retain control over the assets and their income. This type of planning involves the combined use of a limited partnership and an international asset protection trust. Importantly, it is not based upon secrecy or violating fraudulent conveyance rules, nor does it result in gift tax problems.

II. FAMILY LIMITED PARTNERSHIP

The plan works by transferring the ownership of a client's assets to a family limited partnership, the owners of which typically consist of the client as the general partner, and an international trust created by the client as the limited partner. This combination creates an impassable *legal obstacle course* in the path of a client's potential future creditors. As the general partner, retaining as little as a one percent ownership interest in the partnership, the client has 100% control over the partnership and its assets. He makes all the decisions, he writes the checks, *he is in control.*

The limited partnership is the first hurdle in the legal obstacle course. Under the law, *a partner's creditor cannot reach the partnership assets*, the creditor can only place a lien on the client's

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[6] If a Settlor creates a domestic trust for his or her own support, or a trust where the trustee has discretion to make or withhold distributions to the settlor, or where the settlor retains a general power of appointment, the trust assets are exposed to the settlor's creditors. *See*, RESTATEMENT (SECOND) OF TRUSTS § 156(2) (1959); RESTATEMENT (SECOND) OF PROPERTY (DONATIVE TRANSFERS) § 13.3 and CAT. a (1986); Ware v. Guilda, 117 N.E.2d 137 (1954). *See also*, *Creditor's Rights Against Trust Assets*, 22 REAL PROP., PROB. and TRUST J. 734 (Winter 1987).

partnership interest.[7] This lien does not give the creditor any voice in the management of the partnership;[8] it only entitles the creditor to the cash distributions that would otherwise go to the debtor partner.[9] Since the client is in control of the partnership (directly or indirectly),[10] he will make no distributions (as such) will be made with respect to his partnership interest until the creditor goes away. Even though the creditor will receive no distributions, the Internal Revenue Service says he must pay tax on the partnership income attributable to the liened partnership interest, *regardless* of whether it is distributed to him.[11] Creditors (and people in general, for that matter) do not like to pay tax on income they do not receive. This first hurdle in the obstacle course provides the client with substantial leverage to bring the creditor to the settlement table, on the client's terms. While beyond the scope of this article, several methods exist for the client to access the partnership funds for his or her own benefit while the creditor is still lurking, without exposing the funds to the creditor.

III. INTERNATIONAL TRUST

If the creditor is particularly unrelenting, the limited partner, which is the international trust established by the client in a "trust favorable" jurisdiction,[12] can liquidate the partnership and receive a distribution of its capital account (typically 99% of the partnership). At this point, these assets are beyond the reach of a U.S. court's judgment, *the foreign jurisdiction where the trust is established should be one which will not recognize a judgment obtained in the*

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7 FLA. STAT. § 620.153 (1991).

8 *See*, FLA. STAT. § 620.152(1)(b) (1991).

9 FLA. STAT. § 620.152(1)(c) (1991).

10 A properly drafted limited partnership agreement would provide for the conversion of the client's general partnership interest into a limited partnership interest upon the occurrence of certain events, such as in the event of bankruptcy.

11 Rev. Rul. 77-137, 1977-1 C.B. 178.

12 Such as the Cook Islands, Isle of Man, Bahamas, Gibraltar, and the Cayman Islands. The laws of these jurisdictions were not enacted to help people defraud their creditors, or gain an unfair advantage over them; their laws, which we view as protective, are a reflection of their perception of a rational, balanced, legal system.

United States.[13] In order for the creditor to reach the client's assets at this point, *he must start his lawsuit all over again* in the foreign country, under its laws, and with one of its lawyers! Only lawyers in the United States can take cases on a contingency fee basis, so if the creditor is adamant enough to try to pursue the assets in the foreign country, he must pay the foreign lawyer from his own pocket, as he proceeds with the lawsuit! The creditor must then convince the foreign court that it has the jurisdiction to hear his case, an alleged wrong which occurred in the United States. If the creditor can overcome that hurdle, which is not likely, he must then convince the foreign court that the client's trust (which is a separate "person" in the eyes of the law) is responsible for the client's alleged wrong. In the very unlikely event that a creditor has the tenacity and financial means to pursue the client's assets this far, the trust can change its situs and governing law to another trust-favorable country, forcing the creditor to start his lawsuit all over again, and so on. In the meantime, the client and his family can continue to benefit from the trust assets and income, without exposing those assets or income to the lurking creditors.[14] When the creditor is made aware of the procedural, financial, and geographical hurdles he will confront in attacking this plan, he usually becomes quite willing to discuss a realistic settlement, rather than pursue the litigation.

One of the objectives of this type of planning is to lower the client's financial profile. The result is to deflect the creditor to another deep pocket or to the settlement table, quickly, before the legal defense fees mount up. The importance of *advance planning* must be underscored for asset protection clients: First, to avoid fraudulent transfer issues,[15] and second, to provide the planner with sufficient time to identify and implement the appropriate planing strategies. Asset protection planning is entirely permissible as long as it is done before the creditor is on the horizon.[16]

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[13] *See, e.g.*, § 13D of the Cook Islands *International Trusts Amendment Act of 1989. See also*, Cook Islands *International Trusts Amendment Act of 1991*, which improved certain protective aspects of the prior legislation, and clarified certain issues relating to community property and trust situs transfer (emphasis added).

[14] *E.g.*, § 13C of the Cook Island Int'l. Trust Amendment Act of 1989.

[15] *See generally*, FLA. STAT. § 726 (1991).

[16] *E.g.*, Hurlbert v. Shackelton, 560 So. 2d 1276 (Fla. Dist. Ct. App. 1990); Eurovest, LTD. v. Segall, 528 So. 2d 482 (Fla. Dist. Ct. App. 1988).

The legal basis for this type of asset protection is not new, the laws have been in place for decades, but law schools do not teach this type of planning. Lawyers are taught how to sue and how to defend, but *not* how to prevent lawsuits. In fact, for many law firms, offering asset protection services could represent an actual conflict of interest, in that it would tend to reduce business for their litigation departments.

IV. FLORIDA LAW

The Florida Constitution[17] and Statutes[18] provide creditor protection via the homestead exemption and the exemption for the proceeds of annuity contracts,[19] among others. Although it is doubtful that the homestead exemption will change, the favored annuity exemption has come under attack in a recent legislative session, and, in the author's opinion, the attack will be renewed in the near future. These exemptions should not be viewed as the "answer" to asset protection; rather, they should be viewed as one part of the solution. The client should recognize that although his home will appreciate, it is not an income producing asset. Further, although the proceeds of his annuity contracts are exempt under current law, the annuity itself is only one type of investment, generally providing a somewhat limited return, and its continued status as an exempt asset is open to question. The sophisticated planning described above is based upon partnership legal principles which are firmly entrenched in forty-nine states (as compared with Florida's special annuity exemption), and the laws of foreign jurisdictions whose revenue depends upon keeping these laws firmly in place.[20]

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[17] FLA. CONST. art. X, § 4(a).

[18] *See generally*, FLA. STAT. § 222 (1991).

[19] FLA. STAT. § 222.14 (1991).

V. TAX CONSEQUENCES

Finally, the entire structure, the partnership and the international trust is usually structured as tax neutral.[21] The client continues to report and pay income tax on the earnings of the trust,[22] and on his general partnership interest in the partnership.[23] The structure may be gift and estate tax neutral as well. Even though the trust is irrevocable, the client-grantor may retain certain powers over the trust which, *for federal estate and gift tax purposes only*, rendering the transfer to the trust an incomplete gift.[24] For married clients, trust would include the estate tax credit shelter and QTIP provisions necessary to achieve the maximum estate tax savings on death, and the partnership may be utilized as the basis for a structured gifting program. Thus, both are easily integrated into an existing estate plan, or they may form the foundation for a new estate plan.

VI. CONCLUSION

Asset protection planning will become more and more important as the explosion of tort litigation and the expansion of theories of liability continues in the United States. How much does this type of planning cost? Typical fees range from $18,000 on up, but considering the immediate savings available to some clients in the form of reduced insurance premiums, and the potential for subsequent savings in the form of legal defense fees *not paid*, the plan will invariably save money, rather than cost money. In today's economic and litigation environment, can a "target individual" really afford not to give asset protection planning serious consideration?

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21 The trust, although irrevocable, contains certain provisions which result in the trust income being taxable to the grantor under Subpart E of Chapter 1 of the Internal Revenue Code (§§ 671-679). The Internal Revenue Service has tacitly recognized this "neutrality" in Revenue Ruling 87-61, 1987-2 C.B. 219, where it held that the § 1491 tax, usually applicable to transfers of appreciated property by U.S. persons to foreign trusts, does not apply to a trust which is taxable to the grantor under the provisions of Subpart E.

22 I.R.C. § 671.

23 I.R.C. §§ 701. 702.

24 *See, e.g.*, Treas. Reg. § 25.2511-2(c) (1983) (emphasis added).