ASSET PROTECTION

Lawsuits abound. Easy credit. Financial reversals. Economic downturns. Failed businesses. We live with the fear and even threat of all of these situations. Daily we hear of lawsuits ranging from malpractice to auto accidents to slip and fall. We live in an increasingly litigious society. In estate planning we plan for the transfer of wealth. To transfer wealth you must preserve wealth. Although there are ways to protect ones assets, I find that most frequently asset protection has more to do with protecting ones peace of mind. First, I will identify the property which is protected under Texas statutes as exempt from the claims of creditors. Second, I will outline the basic rules for the availability of a spouse's property to satisfy the claims of creditors. Third I will discuss the use and limitations of trusts, corporations and limited partnerships in asset protection, and the asset protection benefits of traditional and not so traditional estate planning.

Asset protection, it sounds like a reasonable goal. You protect your assets from wind, rain, hail and other unforeseen occurrences with insurance. It is reasonable to protect your assets from unforeseen economic reversals and lawsuits also.

Protect your assets from whom? Your creditors. What if you borrow money from a bank and pledge your stocks as collateral? If you later cannot pay the note to the bank, the bank can sell your stocks. If you borrow money and give your bank a financial statement reflecting the assets you have, in essence you are showing the bank that if your income situation changes, you have these assets to fall back on.

So what assets are you protecting from whom? Let's look at what we're talking about so we can decide what we legally can and can't do. The seemingly unrelated analogy of wind, rain and hail provides us some insight. You use insurance to protect you from something you hope will never happen and which you cannot foresee. The key word is "unforeseen". If the liability is "foreseen" and you transfer assets to avoid the liability, then you have deceived your creditor. The transfer will be set aside as a fraudulent transfer. But within these parameters, let's look at what you really "need" to do and what you can do.

What creditors are we talking about? In most instances we are talking about judgment creditors: a person who obtains a judgment by claiming you wronged him in some way, be it malpractice, an automobile accident, a business deal gone awry, etc. In some circumstances, the creditor could be a contract creditor. Generally, if your assets were "protected" prior to the time of the note or other contract, the assets continue to be protected.

So we can see who we might be protecting our assets from. What assets need protection? Some assets are protected under Texas laws. Protected property is referred to as "exempt" property; property which is

exempt from the claims of creditors. As a matter of fact, Texas has one of the most favorable exemption laws of any state. In Texas, it is theoretically possible to go through a bankruptcy and come out a millionaire. Sounds strange, right? Texas and a few other states have such favorable statutes that there have been efforts to limit the exemptions available in bankruptcy court. As I was writing this booklet in the summer of 1998, a statute was pending before Congress to limit the exemptions available in bankruptcy court. And on reviewing the booklet in 2003, no statute has been passed but some proposal has been pending in Congress almost continually for the last five years to limit the state exemptions available in bankruptcy court.

But in Texas, even if your home is worth $1,000,000, it is all exempt.

Let's look at the type of property that Texas law protects. Texas protects your home, some of your personal property, the cash value of your life insurance policies, annuities issued by life insurance companies and your retirement plans.

Your home. Texas wants to protect everyone's home. Your home includes up to one acre of land in the city. If you live in the country, your home includes up to 100 acres if you are single and 200 acres if you are married. Texas exempts the entire value of your home. Most states limit the home exemption to a dollar amount, eg., the value of your home up to $10,000. But in Texas, even if your home is worth $1,000,000, it is all exempt. As a matter of fact, Texas not only wants to protect it from creditors, Texas has historically wanted to protect your home from you. As most of you are aware, until 1997, the equity in a home could not be used as collateral for a loan unless the purpose of the loan is to purchase the home or for improvements to the home. Therefore, until recently if you had financial difficulty and would like to use your home as collateral for a loan, you could not do it.

Your personal property up to $60,000 for a family, $30,000 for a single person, is exempt from creditors. Personal property means tangible personal property like a car, furniture, jewelry, clothes, two horses, 120 chickens and all of those items we all have at home - well, perhaps a few of them are unusual. The statute exempts all of these items so long as they are not valued over $60,000. If you have personal property which is worth more than $60,000, not all of it would be exempt, only $60,000 of it would be.

Now we have a million dollar house and $60,000 of personal property, what else is there? These two exemptions have been available for as long as I have been practicing. Three new exemptions have been added since about 1990; the cash values of life insurance policies, funds held in retirement plans (both qualified plans and IRAs) and annuities issued by life insurance companies. The validity of each of these statutes in exempting these types of property was disputed in court. Now that the dust has settled, it appears that we effectively have all of these exemptions.

The exemption for the cash value of life insurance is unlimited. If your cash value is $300,000 it is all exempt. Now, you may want to have a policy with a limited

life insurance portion and a large cash value. Well, if you go too far, the policy is not considered life insurance, so there are limits. It goes back to the old saying, pigs get fat and hogs get slaughtered.

Can you transfer $100,000 into an IRA each year and protect it? No. The state really wants a retirement plan to be a retirement plan, so the statute provides that the amount held in the plan must have been deductible under the tax laws in order to be exempt. All kinds of retirement plans are exempt - qualified retirement plans, Keoghs, IRAs, etc. The retirement plan exemption has no dollar limit. Could we have $700,000 in a retirement plan? Absolutely.

Many people were surprised when the legislature added annuities which are issued by a life insurance company to our list of exempt assets in 1993. As you might be aware, investment in a variable deferred annuity is essentially an investment in a mutual fund. Therefore, you can structure all of your assets in exempt assets and still have diversity of your investments.

In summary - Your home... regardless of the value, is exempt. A qualified retirement plan or an IRA is exempt as is the cash value of life insurance and annuities issued by insurance companies. These are the biggies. You can also throw in a few cows and sheep.

And if you declared bankruptcy could your creditors reach these? No (unless they change the federal bankruptcy laws). ...except one creditor can reach all of this property - can you imagine who? The IRS.

What if you have no creditors, are not engaging in any risky business, being very conservative, etc. and then your spouse is sued and the plaintiff obtains a huge judgment against your spouse? Can the creditor come get your property? That depends... (Wouldn't you know it, a typical lawyer's answer.)... on the type of creditor and the character of the property to be protected.

The "type" of creditor sounds strange - do I mean corporate or individual, male or female? No, actually I mean tort or contract. Did the creditor sue your spouse on a contract, such as a default on a note or did the creditor sue your spouse for a tort, such as an automobile accident or malpractice. The former is a contract creditor and the latter is a tort creditor.

A contract creditor can reach all of the liable spouse's community and separate property. The Revocable Living Trust is a trust which is created to hold and manage the nonliable spouse's share of joint management community property. A tort creditor can reach all of the liable spouse's community and separate property, the nonliable spouse's share of joint management community property and the nonliable spouse's sole management community property.

.....one creditor can reach all of this in the IRS

Perhaps you would like to know what all this community, separate, sole management, joint management terms mean. Let me digress for just a minute and explain the types of property we have in Texas. 1) *Separate property* - property

owned prior to marriage, property received by gift or inheritance during marriage, partitioned property, and property which the spouses agree in writing will be the separate property of a spouse; 2) *Sole management community property* - property which would belong to you were you not married and which is subject to your sole management and control; for example, income from your separate property or your earnings; 3) *Joint management community property* - all other community property owned by a couple.

So we have only one category that is exempt in all situations - that's the nonliable spouse's separate property. CAVEAT: Separate property which is "commingled" with community property becomes community property; therefore, you must keep careful records.

Let's summarize what the above information means in the context of asset protection. First, if you own only exempt property, you do not need to do any further asset protection planning. Second, if only one spouse is involved in an area that could generate a lawsuit, then the other spouse's separate property is protected. For example, let's assume one spouse is a doctor, lawyer or accountant and thus subject to

CAVEAT: Separate property which is "commingled" with community property becomes community

malpractice claims. The other spouse is a corporate executive. The couple owns exempt community property.

The corporate executive spouse also owns nonexempt separate property. The couple owns no property which could be reached by a tort creditor of the professional spouse. ("Professional spouse" sounds like the spouse is an expert at being married.)

Hmmm, could we partition our property and have the corporate executive spouse own all of our nonexempt property and the "professional" spouse own all of the exempt property? Possibly, but that is a transfer and whenever you have a transfer of property, you must make sure there are no "foreseen" liabilities or the transfer is considered a "fraudulent transfer" and can be canceled, can prevent you from obtaining protection through bankruptcy and can have other nasty consequences.

Let's assume you have taken all of the above steps and you DO still need asset protection. You own non-exempt property and you have all these creditors who want your property: what can you do? Nothing. What?!! (Shades of rage!) Why another newsletter just to say that? Does that mean if you have all exempt property you are safe, but if you have non-exempt property and need protection, you cannot do *anything?* Yes. In this scenario, you would encounter fraudulent conveyance restrictions.

If you have existing creditors, you cannot take any action to protect your assets from them. Every action you take to protect your assets will be scrutinized to see if the conveyance is fraudulent. So let's look at the character of a fraudulent conveyance. There are two types of

fraudulent conveyances: actual fraud and constructive fraud.

Actual fraud is transferring your assets with the explicit intent to defraud your creditors. Hmmm, sounds like you can transfer assets as long as you do so without intending to defraud your creditors. True, and intent is hard to prove, so the courts came up with actions they considered indicative of fraudulent intent. These are called the "badges of fraud." These "badges of fraud" have now been included in the statute. The most important is the insolvency of the debtor, but a few others are: Was the transfer to a relative? Did the debtor retain possession or control?

Constructive fraud is the legal way of saying, if it looks like fraud, and smells like fraud; it is fraud, regardless of what you "intended." A transfer is constructively fraudulent if two things exist. First, the debtor transfers property or incurs an obligation and does not receive a reasonably equivalent value in exchange for the transfer or obligation. For example, a gift. Or, for example, the debtor "sells" a car worth $20,000 and only receives $5,000 for it. Second, the debtor has to be insolvent at that time or become insolvent as a result of the transfer or obligation.

But, true asset protection involves structuring the ownership of your assets to protect them from *future* creditors.

So now we've set the stage - you have non-exempt property and no existing creditors from whom you are trying to protect your assets.

What can you do? From this point on, we will assume that you are not making a fraudulent transfer.

Clearly, you can give away all of your property - to charity or anybody and your future creditors cannot reach it. Probably not what you had in mind. Perhaps you wanted to benefit from the property in some way, or at least have control over it.

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Trusts. Trusts are not just for the wealthy, and there are many different kinds. Let's look at a few of the easier ones and go from there. If you create a trust for someone else and you retain no benefits in the trust, the trust cannot be reached by your creditors.

Big deal, you say, since you don't benefit from it. But, if someone on whom you spend money benefits from it, it may help you. For example, your children. Not only are your children one of your major expenses during their childhood, but then there's college, and after that...marriage, a home, a business, grandchildren's college. (Who said it ended after graduation from college?)

Great for the kids, but what about you? What about a trust that benefits you directly? Well, there are several trusts which can be set up for estate planning purposes; benefitting you and also protecting your assets. However, you still are not the sole beneficiary. For example, in a charitable remainder trust,

you receive a fixed amount or percentage of the trust each year. Upon your death, or yours and your spouse's deaths, or at the expiration of a term of years, the property remaining in the trust is distributed to charity.

Well, perhaps although you receive the income, that's not exactly what you had in mind. A Grantor Retained Annuity Trust (GRAT) works the same way, except the persons who receive the property, after the expiration of a fixed term, are your children or any other designated beneficiary.

So what does this protect? The property in the trust cannot be reached by creditors, but the income stream you receive can.

What if you need the property itself? Not much you can do.

What about a trust of which you are the sole beneficiary? If the property was placed in a spendthrift trust by someone else (for example, your parents), your creditors cannot reach the property. Don't dismiss this too quickly. Anything, no matter how small or large, you receive from your parents can be protected. If structured properly, you can even be the trustee of the trust.

> ...true asset protection involves structuring the ownership of your assets to protect them from *future* creditors.

What is a "spendthrift" trust? Section 112.035(a) of the Texas Property Code provides that a person may provide in the terms of the trust that *the beneficiary may* not voluntarily or involuntarily transfer the income or principal of the trust before it is actually paid or delivered to the beneficiary by the trustee. In other words, the beneficiary has no rights in the money until he gets it.

The key is to examine the interest of the beneficiary. In a spendthrift trust, the beneficiary cannot transfer the interest to another person. Therefore, the beneficiary's creditor cannot transfer the property to himself since the creditor basically has the same rights in the trust that the beneficiary does.

If the trust provides for mandatory distribution of all of the income from the trust, the beneficiary's creditors can garnish the trust and receive the income from the trust. If the trust provides for distribution of the income in the discretion of the trustee, then the creditor's ability to reach the income will depend upon whether a distribution is required under certain circumstances, and, if so, do those circumstances exist.

So if all of my property is held in a spendthrift trust, with discretionary distribution of income and principal, it's protected - so why not transfer all of my property to a trust? Now, if it is too good to be true, it probably isn't true. First, there is no reason, tax or otherwise, that you would transfer all of your property to an irrevocable trust structured so that you retain all of the benefits of the trust with none of the control.

The Texas Property Code also provides that a debtor cannot create a trust for himself, retain benefits in that trust and

protect the trust from the claims of creditors by using a spendthrift clause.

If a debtor is the grantor of a trust, then the grantor's right to receive all of the income will subject that income to a garnishment by the grantor's creditors. Hmmm, what about a right to receive income in the discretion of the trustee? If the grantor is the sole beneficiary - the creditors can compel the trustee to pay them the maximum amount of trust income or principal payable to the grantor under the terms of the trust.

OK, Forget Texas, how about Alaska - doesn't Alaska have protected trusts? Actually Alaska passed a law in 1997 which allows individuals to create trusts in Alaska which are protected from their creditors. Great! Is there a catch? You have to have an Alaska trustee. - are you surprised? - why do you think Alaska passed the statute? In addition, the statute is relatively new and its limits have not yet been tested. However, the requirement that the trust must have an Alaskan trustee has generally been a sufficient deterrent for most Texas residents to keep them from using this type of trust. Keep in mind that if you already need protection, you cannot gain protection by *any* transfer.

Ok, what if the grantor is not the sole beneficiary? Some courts have held that the grantor's interest in the trust cannot be reached if there are other beneficiaries of the trust. Trusts of which the grantor/debtor is not a beneficiary are protected. But, that goes back to the rule that if you give the property away and retain no interest, the property cannot be reached. For example, a 2503(c) or a Crummey trust created exclusively for the children of the debtor is not subject to the claims of the debtor's creditors.

And if the grantor wants to say who gets the property later? Retaining a right to decide who receives the principal of the trust which includes the right to pay it to yourself or your estate is a "general power of appointment" over the trust principal. Having this right, subjects the trust principal to the claims of the grantor's creditors.

I know, you are sick of all the trade-offs you have to make in setting up a trust. What about some technique that allows you to keep the benefits from the property as well as the control over it, but which keeps your creditors from reaching them? Yes, the "have-your-cake-and-eat-it-too" technique. There is a technique which is sold on this basis - the family limited partnership.

Family Limited Partnerships! The have-your-cake-and-eat-it-too ! ! ! ! ! ! ! ! ! *(drum roll).* Well, maybe not that dramatic...but it does have a touch of magic.

The Family Limited Partnership owns all of your property in a family limited partnership and you retain full control over the management and investment of the property as well as keeping all of the benefits of the property. Having your cake and eating it too. →→→Isn't this the solution? As long as one of these magic vehicles is created before there are any creditors. In addition, the family limited partnership is not an *exempt* asset. If you file for bankruptcy protection, the family limited partnership is one of the assets which is available to satisfy the claims of creditors.

Doesn't this do it all? Not quite. But it is not to be discarded either. It certainly has a place in a well-planned estate and business plan . Let's look at the reason why limited partnerships came to be considered as asset protection devices and then look at their limitations and other uses.

Under the Texas Limited Partnership Act, a creditor can obtain a "charging order" against the debtor's limited partnership interest. The "charging order" entitles the creditor to receive any distributions to the debtor made from the partnership. The creditor becomes an "assignee" of the debtor's limited partnership interest. An assignee does not become a substitute limited partner. The assignee has no right to vote on any matters that the limited partner does, nor does the assignee have the right to look at the books and records of the partnership. So what does the assignee get if there are no distributions? A K-1. What's a K-1? A K-1 is the tax record which reflects the limited partner's share of profits and losses of the partnership. So even though the partnership may not have distributed any of the profits, it may have profits which must be reported on the limited partner's tax return.

> So what does the [creditor] get if there are no distributions? A K-1.

Let's run through an example to see how this might work. Let's assume that the debtor transferred all of his non-exempt assets to the limited partnership. The debtor and his wife own all of the limited partnership interests and are the **limited partners**. The **general partner** is a limited liability company [or it could be a corporation but if so it should be owned at least 51% by the debtors children - or other persons - and 49% or less by the debtor and his wife.] The purpose of the partnership is to make investments; therefore, the partnership would like to retain the income for additional investments. The general partner has the right to accumulate all of the income for the business of the partnership.

Let's assume that the partnership has $100,000 of income each year. A creditor obtains a judgment and a charging order against the partnership. The partnership does not distribute any of the income, so the creditor receives no distributions. However, the creditor receives a K-1 which reflects the debtor's share of the income as $49,000 which must be reported by the creditor on his tax return. Do you think the creditor likes this situation? Of course not. It seems like "the stink theory of asset protection." You protect your assets by making them so unattractive that no one wants them. Generally, a debtor in this position is able to work out a settlement with the creditor in which the creditor takes some amount of cash (much less than his judgment) and releases the judgment.

What if the creditor is a bank and can afford to sue to force a distribution? The effectiveness of the limited partnership clearly depends on a number of factors including the amount of the claim, the amount of the money held in the partnership, the economic position of the creditor (i.e. can he absorb the income tax consequences of the limited partnership and out wait the debtor) and the solvency of the debtor.

Let's assume the debtor is insolvent. If the debtor declares bankruptcy, the bankruptcy court will set aside the debtor's exempt property for the debtor's use. However, the partnership interest is not an exempt asset. Therefore, the partnership interest is an asset of the bankruptcy estate and the trustee will dispose of it as an asset of the debtor. Due to its lack of marketability, the limited partnership interest is not worth an amount equal to the debtor's proportionate interest in the partnership assets. Ideally, the debtor would want a member of the family to own the partnership interest. If a member of the debtor's family or other "friendly" purchaser is not available, the interest may be sold to a third party.

> You protect your assets by making them so unattractive that no one wants them.

Since partnership interests are not exempt, these partnerships are generally used by people who do not anticipate the necessity of ever declaring bankruptcy. Their goal is to preserve their assets for their retirement. They are willing to address the hassles of having a judgment creditor should the situation arise.

What if the debtor needed some of the funds held in the limited partnership and the creditor had obtained a charging order against the limited partnership interest? The general partner is entitled to receive a management fee for managing the partnership. If the debtor was an officer of the corporate general partner (or a manager of a limited liability company) and responsible for the management of the partnership, he could receive a salary for his services in managing the partnership.

Is there a downside? The downside is the cost of creating and the hassles in maintaining the limited partnership. The partnership is a tax reporting entity, thus a tax return must be filed for it and a separate set of books must be maintained. In addition, if the general partner is a corporation, the corporation must also file a return and keep separate records.

Documentation and accounting are critical. If you do not treat these entities as separate, neither will the courts. For example, if you want to pay your child's college tuition with income from one of your investments owned by the limited partnership, you must not write a check from the partnership to the college. You should write a check to the corporate general partner for the general partner's management fee. In turn, the corporation should write a check to you for your salary. Then you may write a check to the college for the tuition.

But you are disappointed. You wanted a magic, bullet-proof solution. To every advantage there is a disadvantage.

Offshore trusts

Are there any other tools in the legal or estate planning toolbox? Yes, the Offshore Trust. However, the offshore trust is an expensive and involved technique, but clearly has its place and is much more effective at asset protection than the limited partnership alone.

An offshore trust is used in conjunction with a limited partnership. All of your nonexempt assets are transferred to the limited partnership and your limited partnership interest is transferred to the offshore trust. The trust is your main estate planning document. It is irrevocable. The flexibility of the trust is in the powers of the trustees to revise the trust. You are the beneficiary of the offshore trust but not the trustee. The trust has three trustees. You are the protector of the trust. The protector has certain overseeing powers.

Documentation and accounting are critical. If you do not treat each of these entities as separate, neither will the courts.

You maintain control of the trust by transferring your limited partnership interest to the trust while maintaining your position as general partner of the limited partnership. However, if a judgment is obtained against you, the trustee of the offshore trust has the power to take any action necessary to protect the assets of the trust, such as dissolve the partnership and take the assets to the country where the trust is situated.

Of course, the assets are in part protected simply by the difficulty and complications in trying to reach any assets held in other countries, especially in an irrevocable trust. Another advantage of the offshore trust is the fact that in some jurisdictions (e.g., Isle of Mann and Cook Islands), creditors cannot enforce a judgment without retrying the entire lawsuit in that country. The creditor's problems may be aggravated further by the court's inability to obtain personal jurisdiction over the debtor.

Since the trust is irrevocable you lose flexibility in using various estate planning techniques to reduce estate taxes. For this reason, the use of an offshore trust should only be used after estate planning techniques are explored and, to the extent appropriate, implemented.

Summary of Asset Preservation Planning:

1. First, and foremost, you cannot implement an asset protection plan if you have existing creditors from whom you are seeking protection. You cannot implement a plan which would be considered constructive fraud.

All planning begins with this premise.

2. Absolute protection is only available in the form of exempt assets. If you want to maximize your retirement and financial security, maximize your ownership of exempt assets.

3. If one spouse is more likely to have creditor problems, consider marital and partition agreements to protect part of the "non risky" spouse's property, including having the "non risky" spouse owning a larger portion of the nonexempt property and the "risky" spouse owning a larger portion of the exempt property.

4. Structure and implement a solid estate plan, utilizing trusts which are suited to your particular needs.

5. In creating your estate plan, consider the use of a limited partnership

to implement portions of your estate plan and/or to manage your property.

6. If you feel none of the prior suggestions is adequate, consider structuring your estate plan through an offshore trust.