ESTATE PLANNING

Ideas to Help You Plan for Your Future

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ASSET PROTECTION: TAKING CARE OF YOU AND YOUR FAMILY

These days it seems that the exposure to litigation is everywhere. People often ask me how they can protect their assets from being taken by creditors if they get sued. People in high-risk professions like surgeons and those in high-risk industries like aviation are quite concerned with the increasing jury verdicts awarded in personal injury cases.

The possible solutions fall into the categories I refer to as low tech and high tech. Low tech solutions are those a person can do with little or no assistance from a lawyer. High tech solutions require assistance from a lawyer well versed in asset protection.

Low tech asset protection includes making sure that you are adequately insured. Most of us can add an umbrella policy to our homeowners insurance, which will insure us for a few million dollars for ordinary negligence such as auto accidents. The cost of these umbrella policies is often less than a few hundred dollars per year.

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You can also put assets into qualified retirement vehicles such as 401(k) plans and IRAs, and those will be insulated from the claims of your creditors in most states. Maximizing your contributions to such plans each year is also good financial planning because the funds in those plans build up tax-free.

If one spouse is in a high-risk business or profession, putting money into a residence, which held by the spouses as "tenants by the entirety" will provide some protection. If the husband gets sued for his negligence his creditors could not execute a judgment upon the house. Often in this situation the husband would declare bankruptcy and his interest in the house would be bought out of the bankrupt estate by the wife for a nominal sum.

If the husband did not go bankrupt a creditor could wait around to see what happens. If the wife dies the entire title to the property would then be in the husband and the creditor could execute upon the property. Or, if the couple sold the house the cash received would not be a tenancy by the entirety, and the creditor could execute upon the husband's half of the proceeds.

Some states exempt the family homestead from the claims of creditors. For instance, in Florida the homestead is exempt regardless of its value. Sometimes people who are facing a potential judgment suddenly become Florida residents and purchase a very expensive house in order to protect their assets. Then, when the judgment is issued, they declare bankruptcy. The Florida homestead would be an exempt asset in the bankruptcy.

The homestead exemption is not as expansive in other states and an attorney should be consulted before reliance is placed upon a homestead providing protection from creditors.

The husband (or wife) who is concerned about potential future judgment creditors could simply turn all of his money over to his spouse as he earns it. If there are no claims of creditors on the horizon when the transfer is made, once the money is in the name of the spouse it cannot be reached by the creditors of the husband.

Transfers, which are made when the husband has been, or is about to be, sued would not be protected. Those are what is called "transfers in defraud of creditors", and can be undone by a creditor in most states.

If the husband has transferred all of his assets to his wife to avoid creditors, and they then divorce, most jurisdictions which have "equitable distribution" of marital assets would give the husband half of what was earned during the marriage, even though given to the wife.

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If this plan of putting assets into the wife's name is used the couple's estate planning should include trusts in the wife's Will so that the assets do not come back to the husband if she predeceases him.

Some estate planning vehicles, such as a Family Limited Partnership, offer protection against creditors with respect to the assets in the partnership. However, you have to give away at least some of the interests in the partnership to other family members. If you retain complete ownership of the partnership your creditors could attach your ownership interest and dissolve the partnership. Even if you give away interests in the partnership, the interests which you retain could be attached by your creditors. However, the creditors would not have control of the partnership and would merely have the right to receive distributions from the partnership when other partners receive them.

These are all rather low tech asset protection plans which can be done without much advice from a lawyer. However, other than the contributions to retirement plans and the Florida homestead, they do not provide protection if both the husband and wife are sued.

If protection for both husband and wife is desired, or if the client is not married, asset protection trusts may insulate property from the claims of judgment creditors. There are two types of asset protection trust, domestic (in the U.S.) and offshore (outside the U.S.).

Many states provide that a trust which you create and of which you are beneficiary will not be insulated from the claims of your creditors, even if the trust is irrevocable and even if there are other beneficiaries. However, in recent years some states, such as Alaska and Delaware, have enacted laws which provide that trusts which have a trustee who is a resident of that state will not be subject to the claims of the creditors of the creator of the trust. The trust must be irrevocable and must be created before any claims of creditors have arisen.

So that the creditors may not reach any stream of payments to which the creator of the trust might be entitled, it is best to give the trustee absolute discretion over whether payments to the creator of the trust and his family will be made.

Since a trust is said to have its "situs" where the trustees are, it would be best to have the trustees of such a domestic asset protection trust reside in, or be a trust company in, a state which has such laws. If a trustee resides in the state where the creator of the trust resides, there is the possibility that a creditor might try to execute upon the trust by serving execution papers upon the local trustee.

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The creator of the trust might be reluctant to simply name a bank in another state as his sole trustee. However, he could name someone he trusts as a "trust protector" and give the trust protector the power to overrule the trustee in regard to investments and distributions, and even give the trust protector the power to fire the trustee and designate a new trustee.

While these domestic trusts sound good in theory there is a potential constitutional flaw. The U.S. Constitution has a clause which requires the courts of one state to give full faith and credit to the judgments of another state. So far no cases have been litigated in which a judgment creditor of the creator of one of these domestic trusts has sought to enforce a judgment in one of these asset protection trust states by invoking the full faith and credit clause.

Litigating the full faith and credit clause might give a judgment creditor pause; however, if the judgment is large enough the cost of the constitutional fight may be well worth it. On the other hand, the creator of the trust will have to pay, or his trust will have to pay, to defend the trust assets from such a claim.

Offshore trusts provide even greater protection against judgement creditors because they do not have to give full faith and credit to judgments of U.S. courts. Places which have favorable trust legislation include The Bahamas, Belize, Cayman Islands, Cook Islands, Cyprus, Gibraltar, Isle of Man, and the Turks and Caicos Islands. The banks in these places trade upon their discretion and their diligence in protecting the assets of the creator of the trust.

We should be clear that just because these trusts are off shore, they are not exempt from US income taxes. In most cases, the creator of the trust will be considered the owner of the trust for income tax purposes and will have to report all of the income. The IRS will consider not reporting the income criminal tax fraud.

The creator of the trust should not retain any extensive power over the trust or the trustee. In one case the creators of an offshore trust retained powers to control the trust and then renounced those power after a judgment was issued against them. The Court directed the creators of the trust to repatriate the trust assets to the U.S. The foreign trustee refused to turn over the assets, and the U.S. Court put the creators of the trust in jail for several months for contempt of court for not complying with the repatriation order.

Again, the creator of the trust might have someone

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he trusts, such as his lawyer or a family member, be a trust protector to give some measure of control over the foreign trustee.

The beauty of an offshore trust is that the creditor has to retain a foreign lawyer and litigate in a jurisdiction in which the deck is very decidedly stacked against the creditors and stacked in favor of the foreign trustee. The whole idea was to generate business for the banks in these foreign jurisdictions.

Thus, if you choose an asset protection trust you have to make a choice between whether a domestic trust could be subject to U.S. constitutional attack, versus putting your assets in some foreign country.

BEING AN EXECUTOR OR A TRUSTEE CAN BE COSTLY

Abraham Lincoln was once asked about being the President, and he replied, "I feel like the man who was tarred and feathered and ridden out of town on a rail, if it weren't for the honor of the thing I would rather walk."

The same thing might also be said for being an executor or a trustee.

Every year I get three or four cases in which I am asked to defend the actions of an executor or trustee who is alleged to have messed up an estate or trust. In some cases the executor or trustee is partially or totally at fault, and it can cost him or her some serious money.

When you agree to act as an executor or trustee the law presumes that you are aware of all of the duties and obligations of a fiduciary – the generally descriptive term for executors and trustees. The law of fiduciaries has developed over hundreds of years from Medieval land law. It is contained both in current-day statutes, and in court cases which have been decided over the centuries. The law of fiduciaries is something with which many lawyers are not familiar. But if you agree to act as a fiduciary you are deemed to know all of it, and your failure to administer an estate or a trust properly can leave you open to liability.

"If you are asked to act as an executor or trustee, consider carefully before agreeing to do so."

If you are asked to act as an executor or trustee, consider carefully before agreeing to do so. Many times in family situations dysfunctional family members start acting out when an estate or trust is being administered, and there is a lot of aggravation for the fiduciary. If the executor or trustee is a member of the family, he or she can wind up the target of the dysfunctional family members. On the other hand, if the fiduciary is an outsider, he or she can often remain above the family fight.

If you are naming an executor or trustee in your Will, consider whether family members get along. If there is any hint of potential discord consider selecting an outsider to serve as fiduciary. I have seen countless situations where the family member named as fiduciary uses the opportunity to try to assert "control" over other family members, or where feelings of "Mom always liked you best" are acted out against a family member who is the fiduciary. These family fights merely waste your hard-earned money.

Many times people ask name family members to act as fiduciaries, hoping to save money. However, if there is litigation the cost will be much more in terms of dollars and in terms of family unrest than if an outsider or a professional fiduciary, such as a bank, had been used.

If you should find yourself named as an executor or trustee, get the best estate and trust lawyer you can, and remain in continual contact with him or her about your duties as a fiduciary. You do not have to hire the lawyer who happened to draw the Will.

The cost of getting good legal advice will be paid out of the estate or the trust. You do not have a duty to save the estate or trust money on the cost of legal counsel at the expense of exposing yourself to potential personal liability for your actions as a fiduciary.

In several cases I have handled I have seen people who acted as fiduciaries get into trouble because they either got bad legal advice, or because they chose have do things on their own with no legal advice. If you are a fiduciary you cannot afford not to have a good lawyer.

Finally, remember that in being a fiduciary your job is not to try to right some family wrongs. In several cases in which I have seen fiduciaries held personally liable for making mistakes, the fiduciaries have attempted to correct some error which the decedent made in his estate plan, or they have attempted to favor some beneficiary who the fiduciary thought had been short-changed.

Your job as a fiduciary is to administer the estate or trust according to the terms of the Will or Trust Agreement and according to the law. Remember, "No good deed goes unpunished." If you are a fiduciary, stick to your duties and leave ultimate family justice to someone else.

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HELP FOR BENEFICIARIES WHEN TRUST'S INCOME IS LOW

The typical trust usually provides that the income of the trust is to be paid to the beneficiary for his or her lifetime, and upon the death of the life beneficiary the remaining assets are to be distributed to people called "remainderpersons". The word income as used in a trust agreement means dividends, interest and rents; capital gains are not considered income for trust accounting purposes.

In the last few years income beneficiaries of trusts have been noticing a reduction in their income because interest rates have been low and because many corporations have kept their dividends low, making acquisitions with the cash which might have otherwise been paid out to shareholders as dividends.

In many cases trustees have not been of much help to the beleaguered income beneficiary of a trust. The trustees have a duty to preserve the capital of the trust and to invest for some growth of the principal as well as a reasonable income return. Investment in high quality bonds does not generate much of an interest return. The bonds which might generate a higher interest rate are not of investment quality and could result in a loss for the trust if they go bad.

In carrying out his duty to grow the principal the trustee must invest a portion of the portfolio in common stocks, which do not have much of a dividend return.

This dilemma can be solved in two ways. First, when the trust is drafted the problem of inadequate income can be addressed. One way to do this would be to give the trustee discretion to distribute principal to the income beneficiary. The trick there is to make sure that the discretion is broad enough so that the trustee does not have to put the income beneficiary through the wringer trying to justify the invasion of principal. Often, trusts provide invasion of the principal for the health, support, maintenance and education of the beneficiary. I prefer to make the invasion standard broader, and permit the trustee to distribute principal to the income beneficiary, as the trustee considers necessary or appropriate. Then you rely upon the trustee to do the right thing.

> *"The word income as used in a trust agreement means dividends, interest and rents; capital gains are not considered income for trust accounting purposes."*

A second alternative is to draft the trust as a "unitrust". A unitrust directs the trustee to value the trust assets annually, and to distribute to the lifetime beneficiary an amount equal to a fixed percentage of the trust assets. The trust might direct the trustee to pay the lifetime beneficiary, quarterly installments of an amount equal to 5% of the value of the trust assets as of the first day of the year. That amount is distributed to the beneficiary, regardless of what the dividends and interest may be received by the trust.

The beauty of this is that the trustee can invest in whatever will result in the greatest return to the trust; whether it be capital gains on stocks, or interest on bonds. This is the total return theory of investment which has recently come into vogue. If the value of the trust increases the amount paid to the lifetime beneficiary increases because the unitrust percentage is being applied to a higher base; 5% of a $100,000 trust is $5,000, while 5% of a $200,000 trust is $10,000.

A number of states have realized that income beneficiaries of old income only trusts are being short-changed, and these states have adopted, or are considering, new laws which permit the trustee to convert an old income only trust into a unitrust. Generally, these statutes allow the trustee to convert the trust into a 4% unitrust. New York and Florida have recently adopted such statutes. They permit the trustee to either get court approval to convert the trust into a 4% unitrust, or, they permit the trustee to make that decision without court approval and simply notify the beneficiaries that it has been done.

Since the historic total return (dividends and capital gains) on publicly traded stocks is about 10%, the 4% unitrust appears to be a fair result. Based on historic returns that would give the lifetime beneficiary 4% of total returns and leave 6% in the trust to pay the expenses of the trust and to provide some growth to the portfolio.

If you or someone you know is the beneficiary of an income only trust, it might be worthwhile to investigate whether the trust could, or should, be converted to a unitrust.

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