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## The Building Blocks of Asset Protection

Deciding that asset protection is essential to insuring financial security and peace of mind for you and your loved ones is the first step in the process of creating an asset protection plan. Now the question arises: How do you actually safeguard your assets? The next step in planning involves meeting with a trained professional to identify everything of value that you own (or may own), an exercise which, in turn, leads to exploring the suitability of various protections that are legally available to protect your property from potential creditors. Conceptually, the process of creating an asset protection plan is like building a house, with your attorney the architect who designs the plan with your specific concerns in mind .

The building blocks used in asset protection structures include: the corporation, the family limited partnership, the limited liability company, wills, trusts, and an arsenal of offshore tools. To help familiarize you with terminology and uses, here is an overview.

### THE CORPORATION

Incorporating your business is one way to protect some of your personal assets from creditors' claims. To incorporate, you must file articles of incorporation with the secretary of state. The articles establish the corporation as a legally separate entity for liability and tax purposes, apart from the person(s) who started it. This separate identity makes incorporating your business certainly more protective of your personal assets than the sole proprietorship, which is, in the eyes of the law, one and the same as the person who owns it. A corporation is owned by its shareholders, directed by its board of directors, and managed on a day-to-day basis by its officers.

Most corporations are privately owned ("closely held"), although we might be more familiar with the publicly held corporations that trade their shares on the stock exchange. Since a corporation, and not its owners, is generally liable for its business obligations, the most that an owner usually stands to lose if the business starts to struggle is what he paid for his ownership shares; hence, the limited liability protection. However, there are important formalities that must be followed in order to keep your corporation's limited liability protection in the face of creditors' attacks, and non-compliance can subject the officers, directors, and owners to personal liability. Furthermore, because a corporation is taxed on its profits, and owners are taxed on income from corporate dividends, this dual taxation may make it a less attractive vehicle for asset protection than other entities.

### THE FAMILY LIMITED PARTNERSHIP

A favorite component used in planning is the family limited partnership (FLP), which is in essence a limited partnership whose members are related to one another. The FLP, rather than individual members, holds certain family assets, like the interest in a family business. It can also hold title to brokerage accounts, vacation property, or any other asset. Having the partnership own the assets removes the assets from a partner's individual holdings, which consequently prevents creditors from personally seizing them from an individual. It also has the additional benefits of eliminating a portion of the assets from the probate process (the court procedure required to administer the disposition of your property upon your death), maintaining privacy of membership, and potentially offering significant tax advantages in any valuation of assets.

The FLP has at least one general partner, who manages the partnership and assumes liability for partnership debts and obligations. The rest of the members are limited partners who enjoy limited liability for partnership debt, to the extent of whatever they contributed to the partnership's assets (e.g., their percentage of ownership of the family business). Traditionally, one senior family member is designated general partner because he or she often contributes the majority of assets to the partnership, and frequently wants to control the management and distribution of the assets to preserve them for future generations. The limited partners acquire additional ownership with age and/or participation in the family business.

Structuring a family limited partnership by giving the general partner a small interest in the partnership, and limited members a greater interest, restricts creditors from claiming rights to the bulk of the assets. It is critical that the partnership agreement specifies the relative powers and interests of the partners, as well as how assets may be transferred. Any provision for transferability of ownership interest should limit transfers to family members in order to remove the possibility that creditors could become transferees of partnership assets. Frequently, the only legal remedy available to creditors is a charging order, under which the creditor becomes an assignee of the debtor-partner's share in the partnership. As assignee, the creditor has the right to receive distributions that the debtor-partner would receive, which would be nothing if the general partner makes no distributions. The assignee status is particularly unattractive to a creditor since it subjects him to the tax due on his share of the partnership's undistributed income ("phantom income").

A family limited partnership is a formidable defense against creditors, but the general partner does carry the risk of personal liability if it is an individual, since a creditor can go after the personal assets of the general partner to satisfy the partnership's debt. To buttress the FLP against creditors' claims by removing personal liability from the general partner, a popular option is to make the general partner a corporation or limited liability company that, in turn, is owned or managed by the person with controlling interest in the FLP.

### **THE LIMITED LIABILITY COMPANY**

The limited liability company (LLC) can be set up just like the family limited partnership, with features like manager and members, and favorable tax treatment, but it also enjoys the added benefit of protection from personal liability for the manager. The LLC is a relatively new entity in the U.S. (1977), and state statutes govern how it is established. Your attorney should advise you on compliance requirements. In certain circumstances, such as a fraudulent transfer (made intentionally to deceive a creditor), self-dealing (where, for example, a member borrows money from the company and repays it at an interest rate lower than market), or non-compliance with formalities (like commingling of assets, rather than separating personal and company accounts), a court has discretion to freeze the assets held within the LLC, or pierce its protective structure, rendering its members personally liable to creditors. To further strengthen your defenses against creditors, consider establishing an offshore LLC.

### **THE OFFSHORE LIMITED LIABILITY COMPANY**

The offshore limited liability company is similar to the domestic LLC, but it is created in an offshore (outside the U.S. ) jurisdiction in order to take advantage of foreign laws that are more favorable to asset protection strategies than their U.S. counterparts. An LLC properly established in another country will be insulated from the reach of domestic creditors; such creditors will probably have to stake their claims in the foreign court, an expensive and time-consuming prospect that serves as a potential bar to litigation. Even if a creditor wanted to proceed against the offshore LLC, due to the practical barriers, settlement options are frequently tilted in favor of the offshore interests. Your attorney should have a focus in international law, and be particularly well informed of the laws governing formation and dissolution of LLCs in the various countries that offer such protection.

## THE WILL

The most common device used to protect property is the simple will. Its primary purpose is to direct the distribution of your assets to your chosen beneficiaries upon your death. But a will only "speaks" when the testator (the person who makes the will) passes on, providing no protection of your property while you are alive. It matters not that your intentions are carefully specified, for while you are living, the intended beneficiaries possess no interest in your property; it remains your own. If you have access to it, so do your creditors. Furthermore, once you pass away, the contents of your will are proven, or probated, through a court proceeding. The probate proceeding is public, and every state requires at least publication of the event to allow creditors of your estate to come forward with their claims. Known creditors are to be personally notified by your estate's executor. In short, if you are relying solely on a will to protect your assets, your creditors, known and unknown, will be rewarded.

## THE TRUST

A trust is another very common, but extraordinarily powerful, device for protecting and controlling the use of your property. There are four components to a trust: the grantor (or settlor, in non-U.S. jurisdictions), who is the creator of the trust; the corpus, or property held in the trust; the trustee, who is the manager of the corpus; and the beneficiary, who is the recipient of the trust income or corpus. A trust can be revocable, meaning that the grantor always has the power to change it or rescind its creation, or irrevocable, where the trust is intended to endure for a long time and is, for most intents and purposes, not within the power of the grantor to rescind. There are usually significant tax and asset protection considerations to the selection of a revocable versus an irrevocable structure, so make sure you have adequate advice before proceeding. As you might expect, the irrevocable trust is the one that is generally most secure and given preferential tax treatment.

The two basic trust forms are testamentary and living. A testamentary trust comes alive upon your death, like a will. Typically, the testator's will dictates that the trust will be funded by property that comprises his or her estate, and then the terms of the trust will control how that property will be held or distributed. A trustee, pre-selected by you or appointed by the court, manages the trust property and distributes it as directed. As with a will, however, the assets that a testamentary trust holds are indeterminable until your death, and subject to the reach of creditors while you are living.

In contrast, a living (or *intervivos*) trust is an entirely different structure, created to hold assets for your use, or for the use of other beneficiaries, while you are living. To be valid, its corpus must be either funded with property or with an interest in identifiable property when it is created; property can be added to, sold, or otherwise distributed from the trust in any manner that the grantor stipulates. The amount of control that the grantor has over the assets in the trust determines how effectively those assets can be reached by creditors. A grantor who is also trustee retains complete control over the trust, and creditors can compel the grantor to distribute assets held in satisfaction of a judgment for damages. A grantor who is also a beneficiary of the trust (the so-called "self-settled" trust) will, in some states, expose whatever assets he receives from the trust to creditors' claims as well. Indeed, any beneficiary that actually receives trust assets is at risk of having them seized.

For example, if the grantor funds a trust with \$100,000 worth of stock as its corpus, with the intent to preserve the corpus for his children as beneficiaries to receive once they reach the age of majority (18 years old), and reserves for himself the interest earned as present income, creditors can seize the grantor's interest income.

While it looks like a trust offers little protection from creditors when established this way, there are several other ways to draft a trust to provide a safe haven for your property. Referring back to the building block analogy, the trust forms the foundation from which is built a comprehensive asset protection structure. Because of its flexibility in safeguarding your property for a wide variety of purposes, ranging from child or spousal support to charitable giving, the trust remains the most popular component of asset protection plans. A sampling of the variety of trusts follows.

A *discretionary trust* is one in which the assets are distributed at the discretion of the trustee, who is in complete control of the trust. Distributions actually made by the trustee to the beneficiaries can be reached by creditors. The trustee, who is selected by the grantor, is under a duty to perform in the best interest of the beneficiaries and will not make a distribution unless it is, indeed, in the beneficiaries' best interest. Naturally, if a creditor is waiting in the wings for such a distribution to be made, the trustee will use his or her best efforts to not make such a distribution.

A *spendthrift trust* is established for a beneficiary's specific use, like education or maintenance purposes, and is statutorily protected from the reach of creditors. The one caveat is that a grantor cannot create a spendthrift trust for herself, since such a trust would promote abuse by unscrupulous individuals intending to thwart legitimate creditors' claims.

An *irrevocable life insurance trust* provides two kinds of protection from creditors because it is the trust, and not an individual, that owns one or more life insurance policies. The death benefit is out of reach of the beneficiary's creditors, and the cash value of a whole life insurance policy is barred from claims made by the grantor's creditors. This is a particularly useful and simple alternative device for holding insurance policies that may normally be held by husband and wife (each owning each other's policy). In the event of common accident and simultaneous death, the entire death benefit would be taxed if held by a husband and wife. By holding ownership in a life insurance trust, the death benefit is paid outside the estate of each (avoiding the probate process), which might also limit the overall tax obligation of the estate.

An *offshore trust* is an irrevocable, discretionary trust created outside the jurisdiction of the United States, governed by the laws of a foreign country typically selected for its favorable view toward innovative asset protection. Its use must be carefully counseled by an attorney whose focus is in both international and domestic law, particularly that of the state in which the grantor resides, since the interaction of the two will dictate the extent of protection such a trust affords. An offshore trust may be appropriate for individuals whose net worth is \$500,000 to \$1 million or more, or whose assets are considerably more vulnerable to unwarranted attack by creditors. Despite the illusions of many, it is not an appropriate vehicle for tax reduction.

*Trust income*, for U.S. grantor trusts, must be reported to the U.S. Internal Revenue Service, and a properly drafted trust is tax neutral. It is not a vehicle for hiding assets, since hidden assets can always be found when creditors seek to question the grantor about his or her assets by way of a court-ordered deposition or discovery request. And, of course, an offshore trust is not an entity that can be used to defraud creditors. As with all asset-protection components, the offshore trust must be established well before any perceived challenge might be made to ensure its validity and guard against an accusation of fraudulent transfer. The longer the time frame between transfer of assets and any claims on assets, the better.

For those of you who regard offshore trusts with skepticism, know that there is nothing inherently illegal about creating one to protect property that is legally yours. Rather, it is prudent practice to make use of the unique benefits available in a jurisdiction outside your domicile. For example, Delaware is well known in the business world for its favorable laws governing corporations, and businesses incorporate there every day to take advantage of those laws. Individuals seeking to devise an offshore trust do so for many reasons, including the desire for personal privacy, long-term financial security for their families and future heirs, aversion to the litigious climate in the U.S., concerns over potential business failure and insolvency, anticipation of incapacitating illness and corresponding financial drain, and a general fear of what the future holds in terms of economic and political instability.

In order to remove any appearance of control, it is advisable that the grantor of an offshore trust not be its trustee or protector (one or more persons appointed to oversee the actions of the trustee vis-à-vis the trust assets). The trustee, typically a foreign trust company, also should preferably not have any affiliated branches in the U.S. , which could make the trustee subject to a U.S. court's jurisdiction. Creating a trust that prevents the grantor from controlling the assets allows the grantor to raise the defense of "impossibility of performance" when faced with a judgment demanding repatriation of the assets for the benefit of creditors. Tied to the defense of impossibility is a useful characteristic of an offshore trust: its anti-duress provision, which allows the trustee to ignore any court-ordered directive to distribute assets. Contrary to the spendthrift trust rule in the U.S. , a grantor can be a beneficiary of an offshore trust and be protected from future creditors if the trust terms are carefully drafted.

This is just a cursory view of some of the more common asset protection components. The application of these or others to protecting your particular assets should be done with the advice of a licensed attorney or other professional familiar with Asset Protection.

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