Effective Strategies for Asset Protection: Gifts, Exemption, Limited Partnership, and Nevada and Offshore Protection Trusts

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Professionals, investors and business owners are rightfully concerned about the costs of litigation in today's society. Asset protection has become an accepted part of any estate plan. Estate planning has always been about minimizing risks. The risk of losing one's assets in litigation has now been added to the traditional risks of death, disability and income and estate taxes. Any well designed estate plan must deal with each of these risks, and will include the following:

- *Deter litigation* by removing the incentives for plaintiffs and their lawyers to bring litigation;
- *Encourage settlement, rather than litigation*; the estate plan should encourage potential plaintiffs to accept whatever the insurance company can be persuaded to pay, rather than litigate;
- *Simplicity*; the well-designed estate plan avoids unnecessary complexity, and is not difficult to manage;
- *Avoid loss of control*; Successful asset protection planning need not result in loss of control of one's assets.

Effective asset protection planning compliments existing liability insurance, and is most effective when undertaken before problems arise. Effective asset protection planning does not involve excessive complexity, and provides alternatives when problems arise. Often, asset protection planning makes use of more than one strategy.

Reliance on insurance has been a solution for many in the past. All of us are aware that things have changed. Professionals and business owners who previously depended on liability insurance are keenly aware that insurance is not the only answer. The cost of insurance continues to rise, and insurance coverage is not available for every kind of risk. Even where insurance is available, the insured cannot count on insurance always being available. Furthermore, insurance policies always contain limitations on coverage and exclusions from coverage. Punitive damages are often not insured at all. Another common exclusion is intentional acts. All insurance policies limit the insurer's liability, so there is a real possibility that there may not be enough insurance to pay a covered claim.

Gifts of property to others, or holding one's property in another person's name, has often been used as a substitute for asset protection planning. All of us know people whose residences, businesses and investments are held in the names of parents, children or other family members. However, this does not really provide any asset protection at all. There is no protection if the family member becomes involved in litigation, goes through a divorce, encounters tax difficulties, or dies or becomes disabled. When this occurs, the owner is faced with potential loss of the property that the owner was trying to protect.

Exemptions can and should be a part of any estate plan. Most of us are familiar with the homestead exemption, which in Nevada protects from "involuntary" creditors up to $125,000 in equity in a personal residence. Nevada law also exempts from claims of creditors up to $500,000 in individual retirement account (IRA) assets. Exemptions vary from state to state, and are not effective against all creditors. Even the homestead exemption does not protect the residence from being involuntarily sold. Where one's equity exceeds the amount of the homestead exemption, the residence can be sold at execution, and the homeowner receives money in the amount of the homestead exemption. The law provides other exemptions, as well; for example, a limited amount of life insurance is exempt from creditor claims under Nevada law. Most of the other exemptions are limited in amount.

Limited partnerships are an effective and valuable way to protect one's assets. Limited partnerships have been used for years for a variety of purposes, such as reducing estate taxes, minimizing income taxes, and retaining control of one's property. Limited partnerships are frequently an important component of an effective estate plan and asset protection plan. Investors, professionals and business owners should give careful consideration to using limited partnerships as a means to hold investment assets, without loss of control. However, limited partnerships are not suitable to hold all assets. Other strategies must be used for assets such as stock in S corporations, since partnerships cannot be stockholders of S corporations.

Limited partnerships can be drafted to meet a variety of needs and circumstances. The investor, professional or business owner, and the owner's spouse, are frequently named the general partners, and are given the exclusive right to manage the assets of the partnership. A limited partnership that is drafted for asset protection purposes will contain a number of provisions. Such a partnership agreement will give to the general partners wide latitude and discretion in determining whether and when to make distributions to partners of partnership income or assets. Such a partnership will also provide that the general partners will remain in office for as long as they so choose, and will limit or foreclose entirely the ability of anyone other than the general partners to dissolve or liquidate the partnership. A limited partnership that is drafted for investment purposes will confer upon the general partners wide latitude to determine the investments that are appropriate for partnership assets.

Limited partnerships are effective for asset protection because, under Nevada partnership law, assets that are held in a limited partnership are not subject to attachment or execution by a partner's creditors. A creditor must instead obtain a "charging order," which entitles the creditor to receive the distributions from the partnership that would otherwise be made to the partner.

The author's experience is that many creditors do not actually seek charging orders, because the creditor who holds a charging order is taxable on all of the partner's distributive shares, whether or not distributions are actually made. This acts as a substantial deterrent to those who might otherwise attempt to obtain charging orders.

Nevada asset protection trusts were made possible by legislation enacted in 1999. To establish a Nevada asset protection trust, the grantor irrevocably transfers assets to a trustee, who agrees in writing to hold them in trust, for the benefit of the beneficiaries of the trust. Frequently, the grantor and the grantor's family are the beneficiaries of the trust. At least one of the trustees must be a Nevada resident or a bank or trust company that transacts business in Nevada. The trust must be irrevocable, and if the grantor is a beneficiary, the grantor's interest in the trust must be "discretionary," which means that the grantor must not be able to *compel* the trustee to make distributions to the grantor. If the trust meets all of the requirements of the law, the interests of the grantor and the other beneficiaries in the trust cannot be reached by creditors, until assets are actually distributed outside the trust. The principal limiting factor is that, at the time the trust is created, the transfer must not be a so-called "fraudulent transfer;" i.e., the trust must be created before legal problems arise.

Nevada asset protection trusts can be drafted to meet a variety of circumstances. Provisions can be incorporated into the trust for a protector, whose approval may be required before the trustee can take certain actions. Although such a trust must be irrevocable, a well-drafted Nevada asset protection trust will be adaptable to changing needs and family circumstances and to future changes in the law. A well drafted Nevada asset protection trust will also provide a means to change the trustee, if when it becomes advisable to do so. The selection of the trustee is also an important consideration. In the author's opinion, the ideal trustee will be someone who is (i) a Nevada resident; (ii) is trusted by the grantor to act in the best interests of the grantor and the other beneficiaries; (iii) is capable of understanding the trust agreement and will not be apprehensive about doing so; and (iv) can be replaced if circumstances change.

Offshore asset protection trusts have been used for many years. The process of establishing an offshore asset protection trust is not much different than the process of establishing a trust in Nevada. The principal advantage of utilizing an offshore asset protection trust is that laws of some foreign countries provide for legal protections that are greater and more comprehensive than those available in Nevada. For example, under the laws of the Cook Islands, one seeking to pierce through a trust arrangement must litigate the matter in the courts of the Cook Islands; proceedings in other courts are not recognized. Contingency legal fee agreements are illegal under Cook Islands law, and the plaintiff must prove his case "beyond a reasonable doubt." This is the standard of proof applied in criminal cases in the United States, and imposes a significantly higher standard of proof than the "preponderance of the evidence" standard that applies in civil cases in Nevada and elsewhere in the United States. An offshore asset protection trust also provides greater certainty in situations where the Nevada asset protection law has not yet been tested in the courts; for example, in matters involving federal law, or in situations such as family support obligations, where courts might be persuaded to find "implied" exceptions to Nevada's law.

The offshore asset protection trust presents a more formidable barrier to a potential litigation plaintiff, particularly in the case of assets that are located outside Nevada. An offshore asset protection trust will usually have as its trustee a financial institution that is not subject to the jurisdiction of courts in the United States. Such a trustee would not be bound by an order of a United States court freezing the assets of a trust, or directing the trustee to turn over assets held in trust. The potential plaintiff who may be looking for assets will have to factor into the decision process the cost, expense and delay of litigation in a foreign country. Of course, the cost of establishing the offshore asset protection trust must also be considered. In addition to the expense of establishing the trust, the trustee's fees must be paid each year.

Consider Combining Strategies

An effective estate plan will often include more than one asset protection strategy. For example, an investor, professional or business owner can take advantage of available homestead laws, the Nevada exemption for IRA assets, and other available exemptions. The investor, professional or business owner can also establish a Nevada limited partnership, and transfer to the partnership investment securities, cash and other assets. The partnership should not own directly any assets where ownership can give rise to liability, such as some real estate, and operating businesses. These can be owned by the partnership through limited liability companies. A limited liability company that is wholly owned by a partnership is not required to file a separate tax return, but such limited liability company must still be operated as a distinct entity, with its own bank account and its own, separately titled assets. The investor and the investor's spouse can be the general partners of the partnership and the managers of the limited liability companies, and thereby retain control of the assets of the partnership and the limited liability companies. If assets or businesses are held as C corporations, the stock of the C corporations can be held by the limited partnership.

The limited partner of the limited partnership can be an asset protection trust, established either under Nevada law or the laws of a foreign country. The investor, professional or business owner and spouse can own a small percentage of the limited partnership, and the trustee of the asset protection trust can own the great majority (perhaps as high as 98 or 99 percent) of the limited partnership interests. This arrangement should be created at a time when there are no creditors whose claims might possibly go unpaid.

Once the arrangement is created, if legal difficulties arise, the professional has the benefit of the limited partnership. If for some reason the limited partnership is not providing the necessary degree of protection (for example, where a court in another state is not applying Nevada partnership law), and if the limited partnership is properly drafted, the professional can act to dissolve the partnership. If this occurs, each partner will receive a pro rata share of partnership assets. If the asset protection trust holds 98 or 99 percent of the assets, this percentage will be distributed to the trustee of the asset protection trust, to be held under the terms of the trust agreement and Nevada law. Note that until the partnership is dissolved, the trustee of the asset protection trust acted only as a limited partner in the partnership.

An asset protection trust, if created in Nevada, can also be drafted in such a way that management and administration of the trust can be "moved" offshore if the need arises. In this way, the trust can exist under Nevada law, avoiding the additional expense of a foreign trust, until the need arises. At that time, provided the Nevada asset trust is correctly drafted, the trustee can act to change the place of administration of the trust and the governing law of the trust to a more advantageous jurisdiction.

Conclusion

The principal purpose of an effective asset protection plan should be to deter litigation, and to encourage a potential plaintiff to accept whatever the liability insurer is willing to pay to resolve a claim, thereby avoiding for the professional, business owner or investor the expense and distraction that can come from litigation. An effective asset protection strategy will therefore often include more than one of the elements discussed above. Any asset protection strategy should therefore be simple, and avoid unnecessary complexity. In the opinion of the author, the professional, investor or business owner should never deprive herself of the control of her own assets. Strategies such as those outlined in this article should compliment other estate planning techniques, acting as a deterrent to anyone who might threaten to embroil the professional, investor or business owner in costly litigation. Of course, all strategies may or may not be appropriate in any individual case, depending upon the circumstances. The author encourages anyone who might be considering asset protection as part of an estate plan to seek appropriate legal advice, based upon individual needs and circumstances.

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