

Professional and Personal Liability:
Asset Protection Planning

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Mary J. Giganti, Esq.
Waldheger • Coyne Co., L.P.A.
1991 Crocker Road
Gemini Tower I, Suite 550
Cleveland, Ohio 44145
(440) 835-0600
(440) 835-1511- Fax
mgiganti@healthlaw.com

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I. WHAT IS ASSET PROTECTION PLANNING?

Asset protection planning is the process of organizing one's assets in advance to guard them from loss by some financial disaster in the future.

Asset protection planning must be planning for legitimate business or personal purposes and not used as a means to hide assets from creditors, commit fraud or perjury, or engage in fraudulent transfers.

II. WAYS THAT AN ASSET PROTECTION PLAN CAN ASSIST THE INDIVIDUAL.

- A. To supplement malpractice insurance.
- B. To cover a lapse of insurance.
- C. To provide back-up insurance in the event that your insurance carrier fails, goes out of business or does not have the economic means to pay your claim.
- D. To recover from previous economic problems.
- E. To reduce susceptibility from potential lawsuits.
- F. To provide leverage in negotiations with creditors.
- G. To reduce the value of assets subject to risk.
- H. To protect retirement plan assets in the event such retirement plan assets are not absolutely protected from creditors.
- I. To enhance and coordinate the estate planning process.
- J. To protect inheritance.

III. PROTECT YOURSELF WHEN WORKING WITH CLIENTS.

In light of the potential for civil or even criminal liability (e.g., bankruptcy crimes, tax crimes, money laundering, fraudulent conveyances) under certain circumstances, anyone assisting clients with asset protection plans, must use caution. In order to minimize the potential risks associated with assisting a client with asset protection planning, you should (A) know the client; (B) obtain a solvency statement; and (C) conduct due diligence on the client's circumstances.

A. Know the Client. Make sure you know your client including, the source of his wealth; the client's reasons for this type of planning; and whether the client has any current creditor issues or is merely insuring against unknown future creditor risks.

B. Solvency Statement. Obtain a written statement from the client affirming that (1) there are no pending or threatened claims; (2) there are no present governmental investigations; (3) there are no administrative proceedings; (4) no situation has occurred which the client has reason to believe will develop into a legal problem in the future; (5) following any intended transfers the client will remain solvent and able to pay the client's reasonable anticipated debts as they become due; and (6) none of the assets which the client may transfer was derived from any of the "specified unlawful activities" which are set forth under the Money Laundering Control Act of 1986.

If the client has any pending or threatened claims, you should ensure that the facts and circumstances have been fully disclosed and, if it is still appropriate to establish an asset protection plan, the plan should either (1) insure that appropriate steps have been taken to guarantee that adequate funds will be reserved by the client to make future payment to the claimant or (2) the documents should be drafted with provisions requiring that any liability which may result from the existing claims shall be satisfied by the transferee in the event that the liability is not ultimately otherwise satisfied directly by the client.

C. Due Diligence. To protect yourself, it is imperative that you demonstrate your due diligence in investigating the client's situation so that you did not "knowingly" assist a client in a fraudulent conveyance or that you "should have known" that you assisted a client in a fraudulent conveyance. Such due diligence may include:

1. A written statement to the client stating that you are relying on the client's full and continuing disclosure and that a client's failure to full and continuing disclosure is grounds for your immediate resignation.
2. A client's written disclosure of lawsuits, bankruptcies, administrative actions, liabilities, guarantees, IRS audits, and/or convictions.
3. A client's written statement confirming that following any intended transfers the client will be in a position to pay all current bills as they become due and settle all outstanding debt.
4. Copies of the most recent income tax returns (personal and corporate) and financial statements (personal and corporate).
5. Personal references by the current banker, accountant or attorney.
6. Independent search to verify the truth and completeness of the disclosures made by the client.

IV. GENERAL PLANNING GOALS.

While the goal of any asset protection plan will vary as every person's financial situation is different, there are some common objectives:

A. Keep the Plan Simple. An overcomplicated plan will confuse and frustrate the individual it is suppose to protect. An overcomplicated plan can paralyze an individual to do nothing.

B. Keep the Plan Flexible. A properly structured asset protection plan will not lock the individual into a course of action which must be followed regardless of what happens, but should provide the individual with certain options that would not otherwise exist.

C. Reduce Risk. During asset protection planning, one should review all risk exposure, evaluate the exposure and reduce the exposure.

D. Consider All Potential Adversaries. An asset protection plan should be designed to ultimately protect an individual against any potential adversary. For example, if a physician has a concern over the possibility of a malpractice claim being filed against him, the asset protection plan should also protect him from a business dispute with his partner or from a lawsuit by a terminated employee. Therefore, the asset protection plan should provide protection of an individual's assets in a multitude of potential threats.

E. Deter Litigation. An asset protection plan will create an economic cost to a potential plaintiff or creditor. A sound asset protection plan can enhance the individual's bargaining position and posture throughout the course of litigation. Asset protection planning can also deter potential litigation by reducing the value of the assets. A properly designed plan can provide an incentive to creditors to settle inexpensively.

V. PROBLEMS TO CONSIDER WHEN PREPARING AN ASSET PROTECTION PLAN.

A. Fraudulent Transfer Law. An asset protection plan should not be premised upon hiding assets, which can create serious problems. An asset protection plan is not an excuse to defraud creditors. Although there exists uncertainty as to when and to what extent asset protection planning can be implemented, the successful situation is where the planning is completed at a point in time when there are no pending or threatened claims.

The Bankruptcy Abuse and Consumer Protection Act of 2005 increased the look-back period to ten (10) years for fraudulent transfers.

Ohio's fraudulent transfer law is found at Ohio Revised Code Chapter 1336. Under Ohio law, a transfer will be fraudulent as to a creditor (whether the creditor's claim arose before or after the transfer was made) if the debtor made the transfer in either of the following ways:

1. with actual intent to hinder, delay or defraud any creditor; or
2. without receiving reasonably equivalent value in exchange for the transfer and the debtor incurs debts beyond his ability to pay as they

become due or the debtor engages in a transaction for which the remaining assets are unreasonably small in relation to the transaction.

The Ohio Revised Code provides the following factors (badges of fraud) to determine actual intent:

1. was the transfer to an insider (i.e., relative, partnership, corporation);
2. did the debtor retain possession or control of the asset after it was transferred;
3. was the transfer disclosed or concealed;
4. was the debtor sued or threatened with suit prior to the transfer;
5. was the transfer of substantially all of the debtor's assets;
6. did the debtor abscond;
7. did the debtor remove or conceal assets;
8. did the debtor receive the reasonable equivalent value for the transfer;
9. did the debtor become insolvent shortly after the transfer;
10. did the transfer occur shortly before or after a substantial debt was incurred; or
11. did the debtor transfer the essential assets of the business to a lienholder who transferred the assets to an insider of the debtor.

Creditors may either levy on the assets in the hands of the transferee as if they had not been transferred or they may recover judgment from the transferee for the assets or their value. The fraudulent transfer law provides that where a debtor makes a tainted transfer to another person or entity, a court can set aside the transfer as if it never occurred.

The timing of the transfer is an important planning issue with respect to the fraudulent transfer law. The longer the time period between the lawsuit and the transfer the better. A long history of gift giving pursuant to a business or estate plan may also be helpful in these situations.

Insider transfers are not fraudulent in the following circumstances:

1. To the extent the insider gave new value to or for the benefit of the debtor after the transfer was made, unless the new value was secured by a valid lien;

2. If the transfer was made in the ordinary course of business or financial affairs of the debtor and the insider; or
3. If the transfer was made pursuant to a good faith effort to rehabilitate the debtor and the transfer secured present value given for that purpose as well as an antecedent debt of the debtor.

The following are some examples of typical fraudulent transfers:

1. When a debtor is in financial trouble and quit claims his interest in a residence to his spouse, hoping to avoid imposition of future judgment lien thereon arising from a business venture he has undertaken not involving his spouse.
2. When a debtor is in financial trouble and transfers his interest in unencumbered assets to a trust established for the benefit of his children.
3. When a debtor is in financial trouble and transfers money to his children or other relatives.
4. When a debtor is in financial trouble and renounces an inheritance.
5. When a debtor is in financial trouble and transfers accounts to a successor corporation.
6. When a debtor transfers assets after committing malpractice or a tort.

B. Transfers to Lessors or Secured Creditors. Transfers arising from the termination of a lease on default or the enforcement of a security interest are not fraudulent. Thus, if a debtor grants a creditor a security interest in \$50,000 worth of goods in order to secure a \$25,000 obligation, the transfer cannot be attacked as fraudulent unless the transfer was made with the actual intent to hinder, defraud or delay creditors. However, even if the transfer was made with the actual intent to hinder, defraud or delay creditors, the secured creditor would be entitled to a \$25,000 lien on the property.

C. Taxes. An asset protection plan is not an excuse to evade federal income or estate taxes. The asset protection plan, if done properly, should be tax neutral. Tax planning may or may not coincide with the asset protection plan. However, when you transfer assets pursuant to an asset protection plan, you must be cognizant of the estate and gift tax consequences.

VI. ASSETS EXEMPT FROM BANKRUPTCY.

A. Ohio Law.

Ohio Revised Code Section 2329.66 lists the property exempt from execution, garnishment, attachment or sale to satisfy a judgment or order. Besides personal items with modest values, the following assets are exempt:

1. life insurance;
2. annuities;
3. group term life insurance;
4. qualified retirement plan assets, to the extent necessary for the support of the person and his dependents;
5. IRAs, Roth IRAs and Education IRAs, unless assets were deposited for the purpose of evading the payment of a debt, and as long as the assets, payments or benefits are attributable to: (a) contributions within the applicable deductible limits; or (b) permissible rollovers;
6. Keogh retirement plan assets, unless assets were deposited for the purpose of evading the payment of a debt, and to the extent necessary for the support of the person and his dependents; and
7. interests in the Ohio Tuition Trust Authority (Ohio's 529 plan).

B. Federal Law - Bankruptcy Abuse and Consumer Protection Act of 2005.

Educational funds (529 plans) are excluded from the bankruptcy estate as long as they were contributed more than 720 days prior to filing the bankruptcy petition. Only \$5,000.00 of the funds contributed between 365 and 720 days prior to filing the bankruptcy petition is excluded. These funds must be for the debtor's children, grandchildren, step-children, step-grandchildren or adopted children or grandchildren.

IRAs are exempt up to \$1 Million Dollars (not including rollover amounts).

SEPs and SIMPLE plans are now protected under this Federal bankruptcy law with no limits.

Section 403(b) plans and 457 plans are now protected under this Federal bankruptcy law with no limits.

VII. OPTIONS FOR THE ASSET PROTECTION PLAN.

Considering the assets exempt from execution and the Ohio Fraudulent Transfer Act, what are some options for an asset protection plan?

A. How to Hold Title to Assets.

1. Transfer Assets to Spouse. As part of an asset protection plan, one option is to place assets in the less vulnerable spouse's name. However, this strategy exposes the assets to claims of the spouse's creditors and would also subject the assets to probate upon the death of the spouse. Additionally, the assets may be compromised if there is a divorce. An alternative is to place the assets in an irrevocable trust for the benefit of the less vulnerable spouse. This option would avoid probate and address the potential divorce situation.

Assuming the spouse is a U.S. citizen, there is an unlimited marital deduction for gifts to a spouse. Therefore, there will be no gift tax consequences on these gifts. The spouse will take a carryover basis in the asset.

2. Transfer Assets to Children. Another option is to transfer assets to children. However, once the assets are transferred, the assets belong to the children, who may squander the assets. To guard against this, the assets can be placed in an irrevocable trust for the benefit of the children. Also, if school funding is needed, assets can be transferred to Ohio's 529 Plan (or another state's 529 plan) or an Education IRA.

The transfer to children will be subject to gift tax unless it is a present interest gift that falls within the annual exclusion (\$12,000 for 2006). The children will take a carryover basis in the asset. Gifts to Ohio's 529 Plan (or other state's 529 plan) or an Education IRA are present interest gifts. Additionally, you can gift \$60,000 in 2006 for one child's 529 plan if you file a gift tax return and elect to treat the gift as if made in 2006 and over the next four years.

3. Create An Irrevocable Life Insurance Trust. To place the cash value and proceeds of a life insurance policy beyond the reach of a creditor, the life insurance can be transferred into an irrevocable life insurance trust.

An irrevocable (Crummey) trust is a trust where the grantor of the trust cannot:

- a. Amend the trust;
- b. Serve as trustee;
- c. Retain the right to remove the trustee; or
- d. Retain any rights to the trust assets.

The beneficiaries of the trust during creator's lifetime can be anyone other than creator or creator's spouse. After the creator's death, the beneficiaries can be anyone, including the creator's spouse.

All assets owned by the trustee are excluded from both the creator's and creator's spouse's estate for estate tax purposes, except life insurance may be included in the creator/insured's estate if the creator transferred the policy to the trust and died within three years.

All income earned by the trust is excluded from the creator's income tax return since this trust is a separate taxpayer.

Any contribution/addition to the trust is a taxable gift unless the annual exclusion applies. Insurance premiums paid by creator, creator's employer or premiums given to the trustee so that the trustee can pay the premiums are "additions" to the trust. Any asset given to the trustee during the creator's life is an addition unless the creator has an obligation to pay the trustee.

If life insurance is the only asset of the trust, the trust should be administered as follows:

- a. Since no income is earned, no income tax return is filed; however, tax I.D. numbers must be secured which result in periodic correspondence from the IRS which must be answered regarding the status of the trust.
- b. Each year (preferably once each year) the creator should give the trustee the funds to pay all insurance premiums. The funds should not be sent directly to the insurance company since this may create gift/estate tax problems.
- c. When the Trustee receives assets, the trustee must send written notification to all "beneficiaries" to advise them of the amount added and to determine if any or all of the beneficiaries wish to withdraw the assets. This is called the "Crummey power of withdrawal." Without this notification, the addition to the trust would reduce the \$1,000,000 applicable exclusion amount that would otherwise be available at the creator's death.
- d. The trustee must wait to determine if the power to withdraw is going to be exercised before paying the premium; otherwise, the power is a sham and will not be recognized by the IRS. Therefore, the trustee must monitor all of these letters before completing payment.

4. Transfer to Others. Where both spouses are vulnerable to potential lawsuits or in the case of a single person, personal assets could be placed in a limited liability company, family limited partnership or irrevocable children's trust. When completing these transfers, gift taxes and basis must be considered.

B. Retirement Plan Assets.

Whether a participant's interest in a retirement plan is subject to the claims of creditors depends upon the type of plan, the participant's control over the plan, and whether a claim against the plan is filed in state or federal court. A participant's interest in an IRA or a Roth IRA may be subject to the claim of creditors but is protected in bankruptcy. However, qualified retirement plans are protected from creditors, except for tax liens, child support orders and misappropriation of retirement plan assets. In some situations, creditors have attempted to attach the assets of qualified retirement plans where there are only owner-employee participants.

In Patterson v. Shumate, 112 S. Ct. 2242 (1992), the U.S. Supreme Court unanimously held that ERISA's prohibition against the assignment or alienation of qualified retirement plan benefits is a restriction on the transfer of a debtor's beneficial interest in a trust that is enforceable under applicable non-bankruptcy law. Therefore, a debtor's interest in a qualified retirement plan is exempt from the debtor's bankruptcy estate and not subject to attachment by creditors.

Despite the U.S. Supreme Court's ruling in Patterson, several courts have ruled that since a sole proprietor's retirement plan does not have employees as participants but only the owner/employer as the participant, it is not a retirement plan governed by ERISA. Therefore, the retirement plan does not have ERISA's protections and as such, may be attached by creditors. Pursuant to these court decisions, the plan will become a retirement plan governed by ERISA if a non-owner employee is included as a participant in the retirement plan. Then, the retirement plan will have ERISA's protections and cannot be attached by creditors. The U.S. Supreme Court confirmed this outcome in Yates v. Hendon, 124 S.Ct. 1330 (2004), when the Court stated:

The working owner of a business (here, the sole shareholder and president of a professional corporation) may qualify as a "participant" in a pension plan covered by ERISA. If the plan covers one or more employees other than the business owner and his or her spouse, the working owner may participate on equal terms with other plan participants. Such a working owner, in common with other employees, qualifies for the protections ERISA affords plan participants and is governed by the rights and remedies ERISA specifies.

C. IRAs, Roth IRAs, SEPs and SIMPLE Plans.

IRAs, Roth IRAs, SEPs and SIMPLE plans are not covered under the non-alienation provisions of ERISA or the Internal Revenue Code. These assets will only be protected if provided under Federal or state law. As previously noted, IRAs, Roth IRAs and Education IRAs are protected under both Federal and Ohio bankruptcy exemption law (with some limitations), while SEPs and SIMPLEs are only protected under Federal bankruptcy exemption law.

Under EGTRRA, IRA funds (rollover and non-rollover), Roth IRA funds, SEP funds and 403 Plan funds can now be rolled into a qualified retirement plan (if the plan permits). This may be an option to consider for asset protection planning as well as financial planning (e.g., to consolidate plan assets).

D. Use of Insurance.

Regardless of what other strategies might be considered, liability insurance would always be recommended as the primary component. An individual should have several categories of necessary insurance for the purpose of protecting assets. All insurance should be reviewed at a yearly business meeting, including the strength of the carrier, its commitment to the industry, the amount of the insurance coverage and, to a lesser degree, the premium expense. Discovering insurance gaps may be one of the most valuable asset protection service provided.

1. Homeowners insurance. Supplemental riders may be available for coverage lapses or insurance gaps.
2. Automobile insurance. Ensure that the liability portion of such policy is large enough. You may consider coverage of \$1,000,000.00 or more.
3. Umbrella liability coverage. You should consider adding broader liability coverage to the existing homeowner's or automobile insurance policies which may greatly expand the total amount of your liability coverage even though the increased premium may be small.
4. General liability insurance. This should be reviewed yearly to ensure that the individual/business is insured for necessary amounts. Additionally, review the policy to determine any exclusions or gaps which may be in those policies. The present insurance may not cover a given situation and the individual/business may be relying too heavily on such insurance.
5. Malpractice insurance. This should be reviewed yearly to ensure that the individual and entity (if applicable) is insured for necessary amounts. Additionally, review the policy to determine any exclusions or gaps which may be in those policies. The present insurance may not cover a given situation and the individual/business entity may be relying too heavily on such insurance.
6. Employment practices. This insurance should be considered given the increasingly common incidence of discrimination and sexual harassment claims.
7. Indemnification obligations. To the extent that a client has a contractual right to indemnification, the strength of the indemnification and amount should be reviewed.

E. Entity Selection.

1. Sole Proprietorship. A professional is always liable for his own acts. If the professional practices on his own as a sole proprietor, he is also liable if anyone he supervises is negligent and any judgment can be satisfied out of his personal assets. Operating as a sole proprietorship offers no liability protection.

2. General Partnership. Generally, a partnership is formed when two or more professionals or business owners agree to practice or own the business together and share the profits and losses on a predetermined basis. However, a partnership has generally been found to exist when professionals simply practice together and share expenses without a formal partnership agreement. This is significant because in a partnership, each professional is personally liable not only for his or her own actions, but also for those of any other partner or for anyone who in the partnership has supervisory responsibility. A general partnership does not offer any liability protection.

3. Corporation or Limited Liability Company. A corporation or limited liability company provides partial protection to the professional practicing in a group. Although an incorporated professional is personally liable for his or her own acts, a major advantage of a corporation or limited liability company is that a professional is not personally liable for the malpractice of other professionals practicing in the entity, unless he or she is involved in a negligent act. Just because you operate in a corporate form does not necessarily mean you have limited liability. You must do more than merely incorporate. You must operate, look and act as a corporation. If you do not operate like a corporation, creditors of the corporation can ask a court to ignore the corporation and impose personal liability on the shareholders. This is known as piercing the corporate veil. The Ohio limited liability company statute does not currently require the same formalities for continued limited liability as does the Ohio corporation statute. If you practice in the corporate form, you must maintain an up-to-date corporate record book. A corporate record book is generally one of the first items requested in an IRS audit or a lawsuit. All significant corporate transactions must be reflected by the appropriate corporate minutes. Additionally, you should never commingle personal assets with business assets. Personal funds should be segregated from business funds. All transactions between the corporation and its shareholders should be at arm's length and should be documented as such. For example, loans from the corporation to the shareholders should be evidenced by a promissory note with a reasonable rate of interest and terms of repayment. If the corporate or limited liability company form is respected, there is some liability protection. It is important to note that the Ohio limited liability company laws do not have the history and case law that the corporate law enjoys.

Ohio Revised Code Section 1705.19 now makes changing orders the exclusive remedy for creditors of limited liability members.

A single member limited liability company may have no liability protection. A Colorado Bankruptcy Court ruled that a single member's interest in a limited liability company is part of the bankruptcy estate and, as such, the trustee became the sole

member of the limited liability company and now controls all governance of that entity, including decisions regarding the liquidation of the entity's assets. The Court further held that charging orders exist to protect other members of an LLC from having involuntarily to share governance responsibilities with someone they did not choose. The charging order protects the autonomy of the original members. In a single member LLC, there are no non-debtor members to protect. In re: Ashley Albright, 2003 Bankr. LEXIS 291 (Bankr. Colorado 2003).

F. Multiple Entities.

Use of multiple tiers of formal entities has long been a common practice to protect the operations and assets of one entity from another in a related group of enterprises. Under this practice, holding entities (such as corporations, trusts and partnerships) own subsidiary entities that in turn, can own subsidiaries. By placing various business enterprises in separate entities and observing the formalities associated with them, the overall enterprise is thereby able to shield its individual segments from each other.

A professional can create a separate company to own equipment and furnishings which could be leased to the professional corporation. Entities that have valuable equipment and furnishings in a single corporation might consider restructuring so that the present entity becomes a non-professional holding company that would lease the applicable assets to a new professional company. Thus, if the professional company is sued for malpractice, the leasing company's assets would not be exposed.

G. Family Limited Partnership.

A family limited partnership ("FLP") is a limited partnership created under Ohio law comprised solely of family members. It is through this arrangement that a family can protect its accumulated wealth and pass it on to future generations.

There is nothing overwhelming about FLPs except for the relative ease with which they can be created and the results they can achieve. In general, the family needs only to place some assets within a limited partnership with the intention of sharing the profits from their invested assets in order to establish a FLP.

A limited partnership must consist of at least one general partner and at least one limited partner. The general partner or partners has unlimited liability and management control over partnership affairs. In contrast, the limited partner or partners receive limited liability essentially equivalent to that of a shareholder in a corporation and may not participate in the management of the partnership (i.e., a passive investor).

The parents are generally the creators of the FLP because they usually have the most wealth. As the wealth holders, they contribute designated assets to the partnership in exchange for both a general partnership interest and a limited partnership interests. Unless the children have sufficient assets of their own to make a minimal investment in the FLP, the parents gift to their children (or even other family members) minimal limited partnership interests. This initial

interest usually amounts to only a one percent (1%) limited partnership interest for each child. There is no magic to this number, the parents may choose initially to give away a larger interest. However, the parents' gift of the limited partnership interest may generate unwanted gift tax consequences unless the parents use their \$11,000/\$22,000 annual exclusion or \$1,000,000 gift tax exclusion amount.

A FLP is a practical vehicle for assets protection planning due to its flexibility of operations, continuity of management, asset protection, both inside and outside the family limited partnership, consolidation of assets and long-term accumulation of wealth and a positive method of control.

Holding a partner's interest in a FLP does not by itself create a type of personal property ownership that ordinarily is subjected to divesture by a creditor. Being a partner confers more than merely a property right in the asset of the partnership. It actually changes the nature of the property rights. Specifically, each partner is a co-owner of specific partnership property, holding as a tenant in partnership so that the partner's right in specific partnership property is not available to attachment or execution, except on a claim against the partnership itself. Accordingly, assets owned by the partnership in its own name are not subject to satisfy the obligations of its individual partners. Moreover, a partner cannot normally be divested of that particular interest by a creditor in contravention of the partnership agreement. So while a judgment creditor might be able to divest a person of ownership of a share of stock in a corporation or a bank account, a partnership interest is not subject to divesture. A partnership interest may, however, be subject to a charging order. A charging order against a partnership interest is essentially an order by a court that awards a judgment creditor whatever the partner-debtor is entitled to receive from the partnership in a capacity as a partner. Under a charging order, if the partner is entitled to a cash or other asset distribution from the partnership in the capacity of being a partner, it must be made to the judgment creditor. If there are no such entitlements, nothing need to be distributed to the creditor from the partnership and its assets remain intact in spite of the judgment against one of the partners.

The following steps can be taken to enhance the protection afforded by a charging order:

1. The limited partnership agreement should address the status of voluntary and involuntary assignees.
2. The limited partnership agreement should specify the procedure by which an assignee may become a substituted member.
3. The limited partnership agreement may provide for a right of first refusal to limit the salability of the interest by a judgment creditor following the potential failure of the charging order as an exclusive remedy and attachment by the judgment creditor.
4. The limited partnership agreement should address when and how distributions will be made (e.g., all distributions made at the discretion of the General Partner).

5. The limited partnership agreement should limit a withdrawing partner from receiving the value of his capital account, except upon the dissolution of the partnership.
6. The limited partnership agreement should provide that the consent of all the partners is required to liquidate the partnership.
7. All formalities should be respected and followed (e.g., assets titled properly, separate books and records, transactions at arm's length, written resolutions).

H. Judgment-Proof Status.

To achieve judgment-proof status, there should be no exposed assets and/or liens should be placed on the assets, by the proper use of debt, so that no unsecured creditor would have any reasonable likelihood of recovering assets from the entity. Judgment-proofing often occurs naturally as a result of borrowing from banks or other lenders in order to facilitate cash flow and compensation requirements of the entity. The assets most often requiring protection are furniture, equipment, accounts receivable, and any indicia of good will.

1. Building Loans. Often the shareholders will be involved in other loans, such as real estate loans, where the real estate is leased to the business entity and is not creditor exposed. For example, if the shareholders' spouses own the real estate subject to a mortgage, the bank with the mortgage may require that the assets of the business be pledged as additional collateral for the real estate loan. It would usually also be required that the business entity guarantee the loan and that the loan can be accelerated by the bank if the business entity or any shareholder guarantor becomes insolvent. In that event, the bank would require a sale of the business assets and would use the proceeds of the sale to facilitate a pay down on the real estate mortgage. The spouses could purchase the business assets for fair market value and essentially receive the monies back in the form of increased equity in the building.

2. Asset Protection Liens. The landlord of the entity might retain a lease to preserve the right to receive future rents. Such liens are provided for under the lease, but are not perfected unless a UCC-1 Financing Statement is filed. A commercial lease will normally provide that in the event of the insolvency of the tenant or other default, the landlord can accelerate all rents owed for the remaining life of the lease. The result could be that the landlord becomes a secured creditor owed many years rent immediately if a malpractice claimant or other creditor of the entity were to ever receive a judgment or otherwise establish that the entity is insolvent.

3. Accounts Receivable Ear-Marking and Compensation Agreements. When there are multiple professionals in an entity, each of them would normally be compensated based, directly or indirectly, on generation and existence of accounts receivable. Therefore, it would not be unusual for a professional-employee to insist upon

having a UCC-1 secure interest in a portion of the accounts receivable of the entity, or those accounts receivable attributable to the service of the applicable employee. Shareholder-employees may enter into agreements to facilitate having liens on accounts receivable of the entity. Under this arrangement, if one professional is sued, the accounts receivable attributable to the efforts of the other professionals might be protected. The use of this structure could result in acceleration of income because the IRS may claim that the value of accounts receivable has been constructively received at the time that a security interest exists as opposed to later when the cash is actually received as compensation. Most third-party creditors are not aware that the law generally prohibits the assignment or pledging of Medicare accounts receivable.

4. Deferred Compensation Annuity Arrangements. Many professional groups wish to provide for a deferred compensation assurance for practicing professionals in states where annuities and life insurance are protected from creditor claims. Ohio law protects annuities and life insurance. Many businesses wish to protect the value of accounts receivable without causing a taxable event to occur to the professional. One innovative solution is to borrow monies on the accounts receivable and invest such monies in an annuity contract placed in the name of the applicable professional. The bank places a lien on the annuity contract to secure its right to be repaid on the loan and the professional must continue working for the entity for a certain period of time to be vested in the annuity contract. This may provide protection from creditors of the entity and delay the tax on the income attributable to the annuity value.

5. Factoring Accounts Receivable. Clients with cash-flow problems often resort to accounts receivable factoring. Typically, the factor charges per-account fee because the factor bears a risk that the accounts receivable might never be collected and does not have personal guarantees as to the right to be paid. It might be an appropriate income and estate and gift tax planning device to permit a family limited partnership or other family members of the professional to become a factoring entity in order to derive income from factoring the accounts receivable of the professional entity. The Medicare law generally prohibits factoring of accounts receivable that are owed by Medicare or Medicaid.

I. Support Trusts.

This type of trust is intended to provide for the support of an individual. The creator transfers assets to a trust and instructs the trustee to pay so much of the income to the individual for the individual's support and upon such individual's death, to pay the undistributed income (if any) and the principal to another.

The definition of support should be stated in the trust document. Support does not mean subsistence; it typically is defined as that standard of living which the individual is accustomed. The trust document should also address whether other sources of income should be considered. The Trustee has considerable discretion to determine the support standard.

These types of trusts are generally established to insure that an individual has funds available for support without such funds being subject to creditor claims.

J. Protective Trust Provisions.

The following provisions are added to trusts to protect the trust assets and income.

1. Discretionary distribution provisions. This provision vests the trustee with discretion regarding whether to distribute trust income and/or principal to a beneficiary. The discretion may be unrestricted or may be limited by a broadly defined standard. The trustee may also be given the discretion to make distributions on behalf of the beneficiary rather than a direct distribution. The effect of a discretionary distribution provision is to limit the extent of the beneficiary's interest in the trust so as to make it sufficiently tenuous so that it does not qualify as a property right which is subject to attachment by creditors.

2. Spendthrift provision. This provision specifies the grantor's intent that the beneficiary's trust interest is not subject to either voluntary or involuntary alienation. Additionally, a provision converting required trust distributions into discretionary distributions upon the occurrence of certain creditor related events has also been held to be spendthrift provisions. Provisions affecting a forfeiture of a beneficiary's trust interest upon an attempt by the beneficiary to transfer it or by his creditors to reach it is a type of spendthrift provision.

3. Extension Provision. This provision grants the trustee the discretion to extend the trust term in cases where it would otherwise expire at a point in time. Such a provision would be useful in a situation where a trust was about to terminate and distribute assets to a beneficiary who was then battling with a creditor or faced a significant liability.

K. Qualified Personal Residence Trusts ("QPRT").

The grantor transfers his principal residence or secondary residence to a trust called a qualified personal residence trust (QPRT). The trust is for a specific period of time, usually ten (10) to twenty (20) years. The grantor continues to use and live in the residence for the term of the trust. The grantor may even serve as trustee of this trust. At the end of the trust term, the residence goes to the beneficiaries of the trust. If the grantor outlives the term, he may continue to live and use the residence at fair rental value without the residence being included in the gross estate. A QPRT may protect the residence from creditor claims.

The trust beneficiaries will generally not receive this gift until the trust term expires, so their rights are called a future interest, or remainder interest (full fair market value less the value of the retained interest and contingent reversion) and are considered a gift, subject to gift taxes. The longer the trust term, the smaller the remainder interest and the gift taxes. Since gift taxes are only on the remainder interest, the grantor may be able to use the applicable exclusion amount to avoid actually paying gift taxes.

VIII. DELAWARE TRUSTS.¹

Delaware trusts are an alternative to off-shore trusts. Protection from creditors is derived from maintaining these trusts in such a way that the courts of Delaware have exclusive jurisdiction over matters affecting the trust. To take advantage of the Delaware law, a transferor must make a qualified disposition.

A. Qualified Disposition. A qualified disposition is a disposition by a transferor to a qualified trustee by means of a trust instrument.

B. Qualified Trustee. A qualified trustee includes any individual (other than the transferor) who resides in Delaware or an entity authorized by the law of Delaware to act as a trustee and whose activities are subject to supervision by the Bank Commissioner of Delaware, the FDIC, the Comptroller of the Currency, or the Office of Thrift Supervision. Although the transferor cannot act as trustee, the transferor can appoint one or more advisors to the trust, including a trust protector. These advisors can remove and appoint qualified trustees and trust advisors as well as the authority to direct, consent to or disapprove of distributions from the trust or the investment decisions of the qualified trustee. The transferor can serve as an investment advisor to the trust, which means he can direct, consent to or disapprove a fiduciary's investment decisions, but the transferor may not otherwise serve as advisor of a trust except with respect to the retention of the veto right (the right to veto any distribution from the trust if the trust agreement so provides).

C. Valid Trust Instrument. There must be a valid trust instrument which appoints the qualified trustee for the property that is the subject of a disposition and which meets certain express statutory requirements. The trust must expressly incorporate the law of the State of Delaware to govern the validity, construction and administration of the trust. Moreover, the trust must contain a spendthrift clause.

The trust instrument must be irrevocable, but may include the following:

1. the power in the transferor to veto a distribution from the trust;
2. a testamentary special power of appointment in the transferor;
3. the transferor's potential or actual receipt of income from the trust;
4. the transferor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust;

¹ This part of the outline was prepared with the invaluable assistance and practical analysis from Susan C. Murphy, National City Bank, 1900 East Ninth Street, 3rd Floor, Cleveland, OH 44114-3484, phone no. (216) 222-2747, fax no. (216) 222-3173; email address: susan.murphy@nationalcity.com.

5. the transferor's receipt each year of a percentage (not to exceed 5%) specified in the trust instrument of the value of the trust determined from time to time pursuant to the trust instrument; or
6. the transferor's potential or actual receipt of capital from the trust if it is either in the sole discretion of one or more qualified trustees or is pursuant to an ascertainable standard contained in the trust instrument.

D. Other Requirements. The trustee must maintain custody of some or all of the property subject to the qualified disposition in the State of Delaware. Additionally, the trustee must maintain records for the Delaware trust and prepare its income tax returns or otherwise materially participate in the administration of the trust.

E. Tax Implications. The following are the tax implications:

1. Delaware resident trusts are not subject to Delaware income tax on ordinary income or capital gains accumulated for beneficiaries not residents in Delaware.
2. Delaware has no intangible personal property tax to which Delaware trusts are subject.
3. Delaware trusts for non-residents are not subject to Delaware death taxes if the trust does not hold Delaware real estate, Delaware tangible personal property or interests in a Delaware business.
4. Delaware has a special law that facilitates the formation of retirement trusts that can accumulate income and capital gains without incurring federal or state income taxes until the beneficiary begins to receive distributions from the trust.

F. Exceptions. The following are exceptions to the Delaware Act:

1. A creditor may not bring an action (including an action to enforce a judgment) to set aside a qualified disposition unless:
 - a. The creditor's claim arose before the qualified disposition was made and the creditor brings suit within four years after the qualified disposition was made or, if later, within one year after the creditor discovers (or should have discovered) the qualified disposition; or
 - b. The creditor's claim arose after the date of the qualified disposition and the creditor brings suit within four years after the qualified disposition was made.

In addition to the statute of limitations, the Delaware Act attempts to protect a qualified disposition by mandating that a creditor utilize the uniform fraudulent transfer act and no other law to obtain provisional relief against property subject to a qualified disposition. The Act also prevents creditors from seeking relief against trustees, advisors or any person involved in the counseling, drafting, preparation, execution or funding of a trust that is the subject of a qualified disposition. Creditors are thereby limited to seeking relief against the transferor.

2. The following persons are not subject to the Delaware Act:
 - a. A person whose claim results from an agreement or court order providing for alimony, child support or property division; or
 - b. A person who suffers death, personal injury or property damage before the date of the qualified disposition for which the transferor is liable.

G. Consequences if a Qualified Disposition is Defeated. The following are the consequences if a qualified disposition is defeated:

1. Creditor - If one of the above exceptions applies, the qualified disposition is defeated only to the extent necessary to pay the creditor's claim and related costs (including attorneys' fees).
2. Trustee - If the trustee has not acted in bad faith in accepting and administering the trust (its mere acceptance of the trust is presumed not to be in bad faith), the trustee may use trust assets to pay the costs that it incurs in litigating the claim.
3. Beneficiary - A beneficiary who received a distribution before a creditor brings suit may keep the distribution unless he or she acted in bad faith.

H. Comparison with Off-Shore Trusts.

1. Statute of Limitations. The statute of limitations governing the time in which a creditor in a foreign asset protection jurisdiction can seek to negate a transfer as fraudulent is often shorter than under domestic jurisdictions. For example, the Bahamas has a two-year statute compared to Delaware's later of four years or one year upon discovery statute.

2. Litigating in a Foreign Jurisdiction. The foreign jurisdiction makes it more difficult to collect a judgment than a domestic jurisdiction. A creditor will find it more difficult to retain local counsel due to the fact most attorneys in the foreign jurisdiction represent the financial institutions that administer the trusts. Most foreign jurisdictions do not permit contingent fee arrangements with local counsel. Many foreign jurisdictions require the losing party to reimburse the prevailing party's fees. The

plaintiff is often required to post bond prior to commencement of the lawsuit. Finally, the burden of proof (beyond a reasonable doubt) in the foreign jurisdictions is often more stringent than the domestic jurisdictions.

3. Constitutional Issues. There is a possibility that the Full Faith and Credit Clause, the Supremacy Clause and the Contracts Clause of the U.S. Constitution would each allow a creditor to proceed against the assets of a domestic asset protection trust if a valid judgment can be obtained against the trust in a court other than a state court located in the jurisdiction of the trust's settlement. However, this issue has not been tested in court yet. Offshore jurisdictions, which are not governed by the U.S. Constitution, present no such concerns.

IX. CASE STUDIES.

In conjunction with estate planning, Mr. John Smith, CPA and Mrs. Mary Smith desire to protect their assets. They have two minor children. Upon completing an inventory of the assets, they own the following assets:

Inventory of Assets

<u>Asset</u>	<u>Value</u>
Residence	\$500,000
Vacation Home	\$200,000
CPA Firm	\$450,000
Accounts Receivable	\$60,000
Business Building	\$400,000
Retirement Plan	\$200,000
John's IRA	\$50,000
Mary's IRA	\$50,000
Other Investments	\$110,000
Savings	\$20,000
John's Life Insurance	\$1,000,000 with \$25,000 cash surrender value

In conjunction with the estate plan, by using several of the techniques identified in this outline, the assets of Mr. and Mrs. John and Mary Smith may be protected.

Now assume the same facts as above, but Mary Smith is also a CPA. How can the assets be protected?

X. CONCLUSION.

The first goal of asset protection should be to follow good business and professional practice procedures, maintain adequate and appropriate insurance and otherwise take all steps necessary so that the asset protection strategy implementation is not considered to be a fraudulent transfer. The most critical matters relating to implementation of any viable asset protection plan is to do so with proof of the valid business or personal planning purposes and at a time when there are no pending or threatened claims.

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