What Non-Asset Protection Planners Need to Know about the Concept of Asset Protection and Why

By Douglass S. Lodmell and Gary L. Lodmell

Over the past five years, asset protection has become the buzzword for anyone with even average levels of savings and wealth in the United States. There are constant invitations to "asset protection" seminars and solicitations sent for the latest book on how to protect assets and maintain privacy. Ten years ago if someone said the words "asset protection," most people would think of insurance or home security systems. Today, almost everyone has heard of asset protection, and many have actually taken steps to accomplish it. The reason is clear.

In the United States, we no longer feel that our wealth and savings are safe. We are barraged by billboards from attorneys with aggressive names and mascots that tout, "No fees unless we collect!" Professionals and business owners are increasingly aware that each customer—and even each employee—may be a potential threat to their hard-earned dollars. Jury awards continue to spin out of control as the court system replaces the legislature as the preferred method for the redistribution of wealth in the United States. Jury awards for medical malpractice claims alone have jumped 76 percent from 1996 to 1999,[1] not to mention what seems to be an uncontrollable descent upon the perpetual slippery slope of civil and tort liability awards.

No longer is it only the multimillionaire who has begun planning for the inevitable assault on personal wealth. Many people with $100,000 to $500,000 of liquid savings and real estate equity have grown even more concerned than the mega-wealthy since even a modest lawsuit for them could easily wipe out 100 percent of their estate.[2] Planning to protect personal assets has now become not just a luxury, but essential, particularly for medical professionals, business owners, and high-net-worth individuals. For many people, such as dentists, chiropractors, and physicians, there is increased worry. These professionals have the additional liability concerns of hiring a

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staff and running a small business on top of practicing medicine in a high-volume setting. The more success, the more concerns.

WHO DOES ASSET PROTECTION?

As with any new development in any area of business, this relatively new area of law has attracted a host of advocates. These include a growing number of specialists who have chosen to dedicate themselves to this complicated area. These are the leaders who have invented and refined the specific tools and who write the articles for peer review. Many of the readers of this journal have practiced in the asset protection area for the past decade, as the development and use of tools, such as the family limited partnership (FLP) and the international asset protection trust (APT), became standard. Most of the professionals who develop these tools have had their planning tested and are constantly improving and refining their techniques and strategies.

Unfortunately, there are others, even some licensed professionals in some area, that have adopted asset protection as a banner for various schemes and scams promising amazing income tax relief. What most of these promoters really accomplish is to separate their clients from $10,000 to $100,000 of their hard-earned money in the form of fees.[3] These fees are "justified," the scammers say, because the typical client is often promised that he or she will save more than that in taxes in the first year alone.

WHAT DO I NEED TO KNOW?

This article is written to help educate and inform not only the end-user, but also current advisors, regarding the difference between legitimate, tax-neutral, asset protection planning, and questionable planning that will most likely not help protect assets and may even put them at risk. Many CPAs, attorneys, investment advisors, and financial consultants have seen and heard the stories of clients who have fallen prey to promoters that use illegitimate schemes. These schemes often include international business companies (IBCs) and various domestic and offshore trusts that claim to protect assets as well as save on tax dollars. Often, the first inclination on the part of the advisors is to assume that anything claiming to be asset protection planning, particularly if the plan includes the use of an offshore trust, must be an abusive scheme. These advisors will often look no further into the planning and advise clients to stay as far away as possible. In the case of an abusive scheme, this advice is absolutely correct, particularly in light of the fact that there is far more talk and promotion of abusive schemes then there is of legitimate asset protection planning. But to advise clients to ignore legitimate, proven steps that can be taken to protect their assets is like throwing the baby out with the bath water.

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In fact, it is the responsibility of these advisors to educate themselves on the difference between the scams and the legitimate asset protection planning, and to know what really is in the best interests of their clients. No one wants to receive that call five years down the road from a client who has just been wiped out by a lawsuit asking why the advisor did not inform him or her about the tools that would have helped him or her to avoid that loss. In fact, the day is not far off when the advisors may themselves be held responsible if they fail to present the options available to clients—if their clients do in fact incur losses that could have been prevented. Those same advisors will almost certainly be disappointed to learn that asset protection planning really does work, but not after there has been notice of a claim.

To structure clients' estates to avoid and reduce, to the greatest extent possible, the risk that they may one day in the future have their assets threatened by someone they cannot now see, do not now know, and have no reason to believe they will be liable to, has been recognized by the courts as absolutely legitimate and prudent.[4] We plan constantly in all areas of our lives. We buy insurance, take preventive medicine, install home security systems, use child safety seats, and even put on sunscreen. Why then, when it comes to our hard-earned money, are we told that it is wrong to take preventive steps to protect it? The answer is surprisingly clear. The system was built on the theory that one person is entitled to take another persons assets, if that other person makes a mistake that affects them negatively in any way.

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IS IT OUR SYSTEM?

The legal system encourages this attitude in two ways: (1) by allowing contingency fees, and (2) by not requiring the loser in a lawsuit to pay the expenses of the winner.[5] The net effect is that there is no penalty whatsoever for attempting to use the legal system to redistribute wealth. The potential plaintiff and the contingency-fee lawyer see it as a no-lose gamble. The lawyers encourage it, and our society has been trained that "*after any accident call Lawyer X and Lawyer Y.*"

An understanding that life has ups and downs has been replaced with the attitude that if something goes wrong in life, there should be someone to pay for the *pain and suffering*. The United States is one of the few countries that has established this type of system. The result is that the United States is responsible for the vast majority of the entire world's lawsuits and lawyers, with a legal system that is by far the most liberal in the world when it comes to awarding damages.[6]

This, unfortunately, is the new *American Way*.

WHY IS THERE SUCH CONFUSION?

As mentioned, confusion exists because of the proliferation and promotion of tax schemes that are clearly abusive. Although a complete discussion of the full scope and variety of the various abusive tax schemes is beyond the scope of this article,[7] a summary of the basic idea is important to understanding why so many asset protection plans are confused with abusive schemes.

Almost without exception, abusive trust schemes are designed for one thing—tax evasion. These schemes rely on using legal language and familiar concepts, as well as some very logical common sense-type approaches that seem right to the uninformed client. They almost always make a distinction between having and earning money in the United States versus having or earning money in a foreign country.[8] Often, these scams include the use of various domestic and foreign entities that are set up to shift money to a foreign jurisdiction. The promoters of these schemes say that because the money is not in the United States, and because of the many steps taken, no taxes need be paid on the money that is in the foreign jurisdiction until it is repatriated into the United States.

These schemes often seem logical, but they just do not work.[9] The IRS looks through the form of all this and sees that the substance of the transactions[10] was simply to evade taxes. Often, these schemes seem to "work" for a few years, since no one looks at the tax returns. The problem is, that if someone does, the taxpayer is in big trouble. Penalties of 75 percent and back taxes and interest[11] can easily wipe out everything a client was trying to "protect." The fact is that there is no statute of limitations for fraud, and the taxpayer cannot point to the advisor as the scapegoat.[12]

WHAT IS AN ASSET PROTECTION PLAN?

How do these abusive schemes differ from a legitimate asset protection plan? This article has already mentioned the use of international trusts, and family limited partnerships. The questions is, why would a legitimate asset protection plan work when these other plans would not? The answer is simple. A properly drafted asset protection plan is *tax neutral*. The client will pay the same amount of tax after creating a plan as before. It does not rely on hidden accounts or convoluted ownership arrangements. There are no special credit cards necessary to access money, and there is no need to lie. Asset protection planning works because legitimate planners are using established tools, under existing laws, both domestic and foreign, and working within the system to place a *legal* barrier between a client's money and someone who is trying to get to that money. At no time is a plan drafted to evade legitimate tax liabilities.

The use of a domestic family limited partnership (FLP) to act as the holding entity for the client's assets has become a mainstay in modern asset protection planning. The client, as the general partner, has direct and easy control of all the assets in the FLP. The FLP files a Form 1065 partnership return, and all of the income is directly taxed to the partners via a Schedule K-1. Almost always, an *international* asset protection trust (APT) serves as the 98 percent or 99 percent limited partner.

As contrasted with the purpose of an abusive offshore trust scheme, the APT is considered a Grantor Trust[13] for United States tax purposes. Thus the K-1, and hence the tax liability for that 99 percent interest from the FLP, will go directly to the United States grantors, who are the clients, and will be reported on their personal 1040 return. The net effect is a completely *tax-neutral* plan.

A good asset protection plan will also integrate seamlessly with the client's estate plan. Distributions may be made directly from the APT at the death of a settlor and may even include a by-pass, Q-TIP, or credit shelter trust if necessary. If credit problems remain in the estate, the funds can be maintained in the APT for the benefit of the children or beneficiaries. The APT can then be used to protect an inheritance from the beneficiary's creditors, including possible future or current divorce.

As for the true strength of the asset protection, there has now been over a decade of use and significant case law surrounding the integrity of this planning.[14] The courts have been clear, and only when there has either been a fraudulent transfer, fraud, or an improperly drafted plan, have the courts attempted to force entry to the plan.[15] Often, even in those cases, the planning has proven to be so strong that creditors have found it almost impossible to collect anything.[16] Additionally, a properly drafted plan is *statutorily* based, which means planners are using the clear law as outlined by written legislation. This planning has proven and continues to prove that properly drafted plans will *actually* protect assets in the event they are attacked.

WHO MAKES THE DECISION?

When a medical patient is faced with a decision regarding his or her physical health, medical professionals have learned that they *must* clearly explain all the options to the patient. Ultimately, it is the patient's responsibility to determine whether or not to proceed with the recommended treatment. This concept applies equally to decisions regarding the financial well being of clients.

If, after being informed of the available options, clients choose to take the risk of not taking steps to protect their assets, that is clearly their choice. But, as advisors, we should not simply stick our heads in the sand and advise our clients only on estate planning while telling them to just buy more insurance for asset protection. This is particularly true when we have seen first hand that a client can be ruined by a suit because he or she had no protection, or because the claim was somehow "outside" the scope of any insurance he or she did or could buy. That would be irresponsible. The use of a well-designed family limited partnership and international asset protection trust is solid planning that can literally save a client's assets. It is tax neutral. It does not create or increase the risk of audit, and it usually creates only one extra tax return.[17] It encourages better accounting regarding a client's investments,[18] and, most importantly, it allows for a clear, legal escape path for all the assets within the plan, if the day ever comes when the client's assets are threatened. As advisors, we owe it to clients and to ourselves to become adequately knowledgeable in this area and to fully inform clients of *all* their options before we tell them to just "buy more insurance." To say that the day their assets are truly threatened will not come is to ignore the ever-increasing certainty, that for many of our clients, in fact it will.

ENDNOTES

1. *Jump in medical malpractice jury awards hits hard,* by Vicki Lankarge, available at http://www.insure.com/health/medliability201.html. According to the latest edition of *Current Award Trends in Personal Injury* by Jury Verdict Research, the median awards for malpractice claims rose 7 percent in just one year—from an average of $750,000 in 1998 to $800,000 in 1999.

2. *See* note 1.

3. It has been the experience of the authors that most promoters price their schemes on the basis of the client's ability to pay, and the amount of tax that the client will purportedly save. We have witnessed clients pay as little as $10,000 for a complete fraudulent scheme, to upwards of $100,000 in a case in which the client was projected to save over $500,000 in taxes in the first year alone. Not only are these promoters damaging their clients by opening them up to severe penalties, but this billing method is highly suspect under the rules of ethics, at least for an attorney.

4. *Reichers v. Reichers,* No. 21833-94 (Westchester County Supreme Ct., June 30, 1998) N.Y.L.J. (July 8, 1998) at 1. Divorce case in which the court noted that the Trust was established "for the legitimate purpose of protecting family assets."

5. Although most State and Federal courts do give a judge discretion to award attorney's fees to the prevailing party (such as Rule 11 in the case of the Federal system), it is hardly ever used, except in extreme cases, and is not considered a deterrent to filing a lawsuit within the United States legal system.

6. This statement represents the views of the author and the generally accepted fact that the United States leads the world in lawyers, lawsuits, and jury verdicts.

7. The IRS in recent years has taken specific pains to address this issue of tax fraud. There is an extensive Internet summary of the IRS position at http://www.treas.gov/irs/ci/tax_fraud/index.htm as well as various publications, such as Notice 97-24, that can be ordered. Investors in abusive trust schemes that improperly evade tax are still liable for taxes, interest, and civil penalties. Violations of the Internal Revenue Code with the intent to evade income taxes may result in a civil fraud penalty or criminal prosecution. Civil fraud can include a penalty of as much as 75 percent of the underpayment of tax attributable to fraud, in addition to the taxes owed. Criminal convictions of promoters and investors may result in fines up to $250,000 and up to five years in prison. Criminal statutes that may be applicable are as follows:

   Title 18 USC 371, Conspiracy to Defraud the IRS

   Title 26 USC 7201, Tax Evasion

   Title 26 USC 7206(1), Subscription to a False Tax Return

   Title 26 USC 7206(2), Aiding or Assisting in a False Tax Return

   Title 26 USC 7212(a), Corrupt or Forcible Interference with the Administration of Internal Revenue Laws

   Title 31 USC 5314, Records and Reports on Foreign Financial Agency Transactions

8. This distinction is a mainstay of the promotional material and logic behind almost all abusive tax schemes. The reason is that most taxpayers do not need to make the distinction between domestic and foreign source income, since the majority of United States taxpayers only have United States based income. The fact that the United States has chosen to tax on the basis of worldwide income is thus irrelevant, and often unknown. Therefore, when the promoters incorrectly state that foreign source income is *not* subject to United States taxes, the concept seems logical. For those familiar with the Internal Revenue Code, it is somewhat infamous for painting first with the broadest possible brush, and working down from there. When it comes to the principle of income taxation, the Code starts with gross income defined as "Except as otherwise provided in this subtitle, gross income means *all income from whatever source derived,* including (but not limited to) the following items." IRC Sec. 61(a) italics added.

   This is contrasted with many European countries, such as France and England, that have chosen to tax only on income earned within their borders. While the rules vary significantly from country to country, the practice of taxing worldwide income, as the

United States does, is not the prevailing system throughout the world. For a good summary and analysis of the two major methods of taxation, see MGMT/IBUS 450, *International Environment of Business International Taxation,* Griffin & Pustay, ch. 19, International Accounting & Taxation, pp. 716-21, available at http://bsc.tamu.edu/mgmt.www/monteils/27-TAX.html.

9. *See* Note 7.

10. The Supreme Court of the United States has consistently stated that the substance rather than the form of the transaction is controlling for tax purposes. *See*, for example, *Gregory v. Helvering*, 293 United States 465 (1935), XIV-1 C.B. 193; *Helvering v. Clifford*, 309 United States 331 (1940), 1940-1 C.B. 105. Under this doctrine, the abusive trust arrangements may be viewed as sham transactions, and the IRS may ignore the trust and its transactions for federal tax purposes. *See Markosian v. Commissioner*, 73 T.C. 1235 (1980) (holding that the trust was a sham because the parties did not comply with the terms of the trust and the supporting documents and the relationship of the grantors to the property transferred did not differ in any material aspect after the creation of the trust); *Zmuda v. Commissioner*, 731 F.2d 1417 (9th Cir. 1984).

11. The participants in and promoters of abusive trust arrangements may be subject to civil and/or criminal penalties in appropriate cases. *See*, for example, *United States v. Buttorff*, 761 F.2d 1056 (5th Cir. 1985); *United States v. Krall,* 835 F.2d 711 (8th Cir. 1987); *Zmuda* and *Neely*. Civil fraud can include a penalty of up to 75 percent of the underpayment of tax attributable to fraud, in addition to the taxes owed. Criminal convictions of promoters and investors may result in fines up to $250,000 and up to five years in prison.

12. IRC § 6501(c)(1) states that there is an unlimited statute of limitations for assessments for a fraudulent return. This is true even if the taxpayer files an amended return, unless the amended return is filed prior to the due date of the first return.

13. *See* IRC §§ 672-679.

14. For one of the first major cases to be litigated in a foreign jurisdiction *See* 515 *Orange Grove Owners Association v. Orange Grove Partners,* High Ct. Rarontogna, Civ. Div. No. 208/94 (Nov.6, 1995). Although the Cook Island court did allow the creditors claims to proceed and restrain the trust, no judgment was ever entered, and it can be assumed that the claim was settled for a fraction of the trust value.

15. A detailed look at the pertinent cases is beyond the scope of this article, but for a good discussion see Douglass S. Lodmell, JD, LLM, and Gary L. Lodmell, JD, *Drafting Considerations for Offshore Asset Protection Trusts in Light of Recent United States Litigation* Asset Protection Journal Winter 2000 Vol. 1 No. 4.

16. As with the *Orange Grove* case cited above (*see* note 16), since almost no judgments have been entered against asset protection trusts in the various jurisdictions in which they exists, it can be assumed that most are dropped or settled out of court for a sum much less than the original lawsuit.

17. Most international asset protection trusts are designed to be considered domestic for United States tax purposes by meeting the two-part test under IRC § 7701(a)(30) and (31), and thus are not required as a Grantor Trust to file a 1041 or separate tax return. This test for determining whether a trust is considered domestic can be met if (1) a United States court can exercise primary supervision over the administration of the trust, and (2) one or more United States fiduciaries have authority to control all of the substantial decisions of the trust. If, on the other hand, the APT is designed as a foreign trust, or after the APT is "triggered" by accepting a distribution from the domestic FLP and moving money to a foreign jurisdiction, then there may be additional reporting requirements such as Form 3520, 3520A, and TDF 90-22.1.

18. As opposed to simply holding investments that will ultimately be subject to capital gains taxes individually, investments held in an FLP must also file a balance sheet each year on the Form 1065. This will serve as a record for the cost basis of the assets, and will help with the accounting when the assets are ultimately sold. This becomes particularly important with the introduction of more complicated rules surrounding the step-up in basis upon death that were passed in the Economic Growth and Tax Relief Reconciliation Act of 2001, signed by President Bush in June 2001.