Asset Protection Case Studies

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CLIENT #1

John and Mary Smith have not yet implemented any estate planning. John, age 46, is a CPA who audits SEC filings for mid- to large-sized corporations. Mary, 40, is a homemaker. They have two children, John Jr., age 12, and Jennifer, age 14. They are residents of Florida.

John's assets include his accounting practice, a professional S-corporation. The corporation employs four other CPAs and a number of support staff. John values his practice at approximately $4 million. John and Mary own a home worth approximately $1.7 million, with an outstanding balance on their mortgage of less than $800,000. John and Mary own three parcels of commercial real property, all located in the state of Florida. The combined value of these properties is approximately $2.2 million, with combined outstanding mortgages of $1.6 million. John and Mary have joint accounts (bank, savings, and brokerage accounts) valued at approximately $3.5 million. Mary has a separate brokerage account, an inheritance from her grandparents, valued at $750,000. John has a deferred compensation plan valued at approximately $2.5 million and a 401(k) plan valued at $550,000. John has a universal life insurance policy with a face value of $500,000 and a $100,000 cash surrender value, and a $1 million term policy insuring his life. Mary has no life insurance. John and Mary have no credit card debt and John's income from his business is more than enough to meet their day-to-day requirements.

John recently became concerned that the work he does made him vulnerable to lawsuits, as he learned the SEC had changed its policy regarding sanctioning individuals for errors committed. Whereas in the past the SEC had only held the firm liable, they now intended to hold individual CPAs liable. John's concern is that the SEC may qualify as a "super creditor" in the event they should levy a sanction against him.

Florida's Constitution protects the homestead from claims of creditors. This protection is generally unlimited, except that recent U.S. Bankruptcy Court rules

have limited the equity the bankruptcy court is willing to protect to $500,000. Florida also has tenancy by the entireties (TBE). TBE generally protects accounts that are in the name of husband and wife from claims of creditors of either the husband or wife, but not both.

The choice John and Mary face is how complicated they want to make their lives in order to protect their assets. John and Mary decide that, for the time being, it is more important to them to protect their assets, at least until John retires (probably in the next ten years), than to worry about the complexity. Mary is sure she and John can handle the changes.

An estate planning attorney's goal is to provide a reasonable level of protection to clients without unduly burdening them.

Recommendations:

1. Prepare and execute basic estate planning documents: Revocable Living Trusts; Pour Over Wills; Durable Powers of Attorney; Health Care Documents (Healthcare Surrogates, Living Wills, and HIPAA Releases); and Designation of Pre-Need Guardians for their minor children.
2. Asset Protection Planning: Prepare and execute an Alaska Family Limited Partnership (FLP). Prepare and execute two Delaware Self-Settled Spendthrift Trusts. Ownership of the FLP will be held in the name of the Delaware Self Settled Spendthrift Trusts. The ownership distribution will be 1% to the Management Trust (General Partner of the FLP), 80% to Mary's Delaware Trust, and 19% to John's Delaware Trust.
3. Have John and Mary obtain a line of credit against their home equity in an amount sufficient to bring the equity below the $500,000 homestead amount. In the event they are sued, this line of equity can be used to fund their defense.
4. John and Mary will re-title all personal checking accounts in the name of their individual Revocable Living Trusts.
5. Create three Limited Liability Companies (LLCs). These are single member LLCs, the only member being the FLP. These LLCs will be treated as disregarded entities for income tax purposes. The three commercial properties will be deeded to these LLCs. This will allow them to isolate the individual properties, thereby protecting the equity in the properties from claims against the other properties.
6. The savings and brokerage accounts are re-titled into the name of the FLP.
7. John needs to reorganize his business affairs. John needs to keep his professional S Corporation but he needs to establish a separate LLC for his business. He then should enter into an employment contract with the new LLC to hire him as a CPA. He should do this with all of the other CPAs who work for the firm as well. Each CPA should be required to

maintain Errors and Omissions coverage. The LLC should then have a blanket policy for all of them.

8. John's firm should obtain a line of credit against the Deferred Compensation Plan. An advance against the Line of Credit can be used to fund a Corporate Owned Life Insurance Policy on John's life.
9. John's 401(k) is an ERISA plan that meets all the qualifications for creditor protection both under ERISA and Florida Statute 222.
10. Mary's inheritance should be maintained in a separate account in her name. In addition, Mary should invest the money in creditor-proof investments. Florida protects funds invested in annuities and life insurance from the claims of creditors. Mary can also use part of this money to fund a 529 plan for her children. We recommend that the 529 plan be owned by an irrevocable trust with someone other than Mary as the trustee.
11. Finally, John and Mary need additional life insurance coverage — an additional $2 million on John, $1 million on Mary, and a $2 million survivorship policy. These new policies should be owned by an Irrevocable Life Insurance Trust.
12. The cost to John and Mary to set up this plan including the creation of all the entities, filing fees, document stamps, and attorney fees can approximate $60,000.

What has been accomplished? John's and Mary's primary assets are now owned by a partnership. The terms of this partnership are that John and Mary will have no right to income, no right to the principal in the FLP, and no right to dissolve the entity. John, through his Delaware Trust, will only own 19%. If John were sanctioned by the SEC or sued, this would be the maximum extent of his exposure. The line of credit against the Deferred Compensation Plan will protect it from other creditors. Mary's inheritance is protected in the event she is sued. If either John or Mary should die unexpectedly, they have protected their assets and have the necessary liquidity to see the survivor through.

The last bit of advice is that each of them own or lease and drive their own car. This prevents them from being drawn into a lawsuit over a traffic accident involving the other.

CLIENT #2

Bob is a very successful plumbing contractor, having developed and marketed a new plumbing system for high-rise buildings. Bob's business is an LLC. Bob is the manager and an 80% owner, with Bob's father owning the remaining 20%. Bob's business is worth approximately $15 million. Bob's business provides him with more than adequate income to meet his personal obligations. Bob has been married for 17 years and has two teenage sons. Bob's marriage has been shaky for a couple of

years and he feels there is a high probability he will be going through a divorce in the next couple of years. In addition to his business, he has a brokerage account worth approximately $5 million. Bob has always maintained this account in his individual name. However, it would undoubtably be considered a marital asset in the event of a divorce. Bob has no life insurance. Bob's primary concern is that he not be forced to sell his business to comply with a property settlement agreement in the event of divorce.

Bob's case presents some interesting problems. First, Bob believes his wife would not want to participate in the planning and if she did, she would want a separate attorney. Under the circumstances, an estate planning attorney should not represent both because their interests are adverse to one another. At the same time, Bob needs to implement some estate planning and asset protection planning. Bob has a Will that was drawn up by an attorney when his children were small. It names his wife as personal representative, leaves all his assets to her, and if something happens to her, has the assets go to the children. The problem with the Will is that it gives everything outright to the wife, does not have provisions for estate taxes, provides no creditor protection, and does not have any provisions regarding divorce or remarriage. In all respects it is a very simple Will for a very complex estate.

Recommendations:

1. Have Bob sign a Revocable Living Trust. The terms of the trust are such that at his death, everything will go to his wife, unless divorce proceedings have been filed by either of them. In that case, she will be limited to the statutory "elective share" and the balance will go in trust to his children. If the divorce is final at the time of his death, she is to be treated as though she predeceased him.
2. The next issue is the property settlement agreement in the event of divorce. Bob's business depends heavily on him as the proprietor, and for that reason, his estate planning attorney advises him to purchase a universal life insurance policy with a face value of $10 million to provide for Bob's wife and children if he dies before a divorce were filed. Although it is important to Bob to try to keep his marriage intact, Bob knows it is a difficult challenge.
3. With regard to Bob's business assets and his brokerage account the estate planning attorney sets up a Family Limited Partnership (FLP), re-titling Bob's membership interest in the plumbing business and his brokerage account in the name of the FLP. It is hoped that as time goes by, and no divorce is filed, that the transfers will not be a problem.
4. The estate planning attorney establishes two Granter Retained Unitrusts (GRUTs), one for each of Bob's sons. The terms of these GRUTs are 20 years and they are to be funded with 30% of Bob's FLP interest. This leaves Bob with a 40% interest in the FLP. At this point, the estate planning attorney obtains the consent of the Bob's wife to fund the GRUTs, so she

is provided with draft copies the GRUTs to take to her attorney for review. In addition, she is named as the successor trustee in the event something happens to Bob. She consents to the funding.

Two years later, Bob's wife files for divorce. The court rules that the transfers to the FLP were all part of Bob's estate planning and that she still had an interest in Bob's interest in the FLP as marital property. The wife attempts to have the transfers to the GRUTs reversed but the court rules that she agreed to the transfers, the transfers were designed to benefit their children, and Bob did not benefit from the transfers. The wife is awarded 20% of the FLP, an equitable share of Bob's 40% interest in the FLP. Bob as the trustee of the Management Trust, General Partner, tenders a fair market value offer to purchase her share, which she accepts. The net result is that Bob saves his business and provides for his children. Bob still is required to pay child support and alimony but is (somewhat) happy to do so because he has retained his business.

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