

How to Properly Fund and Administer an Integrated Estate Plan

BY JOHN R. GARLAND AND PATRICIA A. BARRON

An integrated estate plan (IEP) folds an individual's traditional estate plan into a structure that protects the individual's assets from any unforeseen future creditor threats. If an IEP's documents are not properly designed, the IEP may be penetrated, allowing a creditor access to the IEP's assets. Just as important as the design, however, is the proper funding and administration of the IEP. To protect the assets of a well designed IEP, the IEP must be funded and administered in a manner that does not inadvertently allow creditor access to its assets.

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The primary asset protection component of an IEP is usually a trust, created or "settled" by the individual (hereinafter "the client") that is governed by the protective laws of an offshore jurisdiction. The IEP also typically includes a domestic limited partnership that is owned 99 percent by the trust as a limited partner and 1 percent by the client as the general partner. There are, of course, design variations on this arrangement that must be considered based upon the client's needs and circumstances.

An overriding principle that the client must observe is that the trust and the limited partnership are entities separate and apart from the client. To a large extent, this principle is what protects the assets owned by these entities from the client's creditors. For this

distinction to be respected by the courts, whether the courts are foreign or domestic, certain administrative formalities must be followed when transferring assets into the IEP, while administering the IEP, and when making distributions out of the IEP.

TRANSFERRING ASSETS INTO THE IEP

Choosing the Assets to Be Transferred

Creating and executing IEP documents does not, in itself, protect assets. If a client's assets are not actually transferred to the IEP, they will not be protected. Additionally, other goals of the structure, such as removing assets from the client's probate estate, will not be met.

The first step in funding an IEP is evaluating the client's overall financial picture. Care must be taken that transfers to the IEP do not violate applicable fraudulent conveyance laws and that the client will remain solvent after the transfers. Therefore, it is important for the client's planner to review the client's financial situation, including any existing or potential creditor difficulties.

The client must also consider whether there will be any "ripple" effect if a particular asset is transferred to the IEP. In some cases, the consent of a third party may be required. An asset may be collateral for a loan, for

example, or stock may be subject to a buy-sell agreement. A transfer may affect the client's rights or benefits with respect to certain property. For instance, the protections afforded by title or property insurance may be lost if the insurance company is not consulted prior to a transfer of real property. Depending on the applicable law, certain types of assets, such as a personal residence, may be exempt from creditor attachment, but only if they are owned personally. Also, in some jurisdictions the transfer of real property may be subject to a transfer tax, or may cause the property to be revalued for property tax purposes, which may make the transfer unappealing. All potentially relevant local, state, and federal tax laws should be reviewed before transferring any asset to the IEP.

Should the Asset Be Transferred to the Trust or to the Partnership?

A client usually prefers that assets be transferred to the partnership rather than to the trust, since, as general partner, he or she will have direct day-to-day management control of the partnership. If assets are transferred to the trust, it is the trustees' responsibility and obligation to manage the assets. Because trust assets are removed from the client's direct control, it is arguable that these assets enjoy a higher degree of protection than those retained in the partnership. In the authors' experience, most clients are willing to give up a small amount of protection to retain direct control over the transferred assets. Again, this may vary depending upon the client's preferences and circumstances.

Note that the potential "ripple" effect must also be analyzed in the context of deciding which entity will own an asset. For instance, a U.S. client will often transfer the family residence, stock in an S corporation, tax-deferred annuities, and certain other assets to the trust instead of to the partnership to ensure that certain tax benefits associated with such assets are retained. One must take care not to cause a negative tax "ripple" by transferring a tax-sensitive asset to the wrong entity.

Segregating "Hot" Assets from "Cold" Assets

The IEP is designed to protect the IEP's assets from the client's creditors. The trust and the partnership each may have their own creditors, however. For example, if the partnership owns a commercial property and a property tenant trips and falls, the tenant will sue the owner of the property—the partnership. The lawsuit could put at risk not only the commercial property, but also other partnership assets, such as stocks and bonds.

For this reason, the client should consider segregating "hot" assets, which carry their own potential for creating liabilities, from "cold" assets, which carry little or no potential for creating such liability. Residential and commercial real estate, motor vehicles, airplanes, boats, and certain general partner interests are examples of hot assets; cash, brokerage accounts, stock, limited liability company interests, and limited partner interests are examples of cold assets. Hot assets could be placed into a separate entity (or entities), such as a limited liability company, which would be owned by the client and the trust in the same 1 percent to 99 percent manner as the partnership. If this separate entity were then sued by the trip-and-fall tenant, the cold assets of the partnership would remain protected.

Transferring the Assets

Each contribution made to the trust should be formally accepted in writing by the trustees. Similarly, if the contribution is made directly to the partnership and if any part of the contribution is to be credited to the trust's 99 percent limited partner interest, the trustees should accept this (indirect) contribution to the trust in writing. Taking this step avoids any creditor argument that the assets were not properly contributed to or accepted by the trustees.

Generally, each contribution the client makes to the partnership should be allocated 1 percent to the client's 1 percent interest and 99 percent (as a nontaxable gift) to the trust's 99 percent interest. It is advisable that the client execute a document directing that each

client contribution be credited in this manner. This document will help avoid any creditor successfully arguing that a contribution should have been credited solely to the client's general partner interest.

ADMINISTERING THE TRUST AND THE PARTNERSHIP

The general partner should handle all transactions involving partnership assets, and the trustees should handle all transactions involving trust assets. It is often the case that a trust "protector" will have veto power over many trustee actions. It is important that, in any transaction entered into by the trustees and over which a protector has veto power, the protector's waiver is obtained in writing. Also, in a typical IEP trust, and for purposes of administrative ease, the domestic trustees can often act without the joinder or consent of the foreign trustee. In that case, however, the foreign trustee should always be notified of any transaction involving the trust.

It is important to note that real property can be and often is transferred to an IEP. However, because real property is not an asset that, if necessary, can be moved from one jurisdiction to another, it may be more difficult to protect if a local court believes a creditor should have access to it. Therefore, the client may wish to draw the equity out of the property through a loan, thereafter transferring the loan proceeds into the IEP. The result is to have converted an "immovable" into a "movable."

Personal residences may also require special treatment. If a client's personal residence is transferred to the trust, the client should be allowed to occupy the residence pursuant to an "occupancy agreement," which sets forth each party's obligations with respect to expenses and upkeep and also provides evidence that the client occupies the residence at the discretion of the property's owners—the trustees. The client may at some time wish to refinance a mortgage secured by the personal residence. If the lending institution requires that the residence be titled in the client's name, a written "nominee agreement" could provide that the trustees will transfer title to

the client as the trust's nominee, but only for the purpose of refinancing the mortgage. The title will be transferred back to the trust after the transaction is consummated. Notification to the lender that the property will be transferred to the trust may or may not be required, depending on the type of property and applicable law.

The trust and the partnership will require separate record keeping, financial statements, and tax reporting. If a loan is made from the entity to the client, which may sometimes be preferable to an outright distribution, loan documents should be prepared, including a promissory note. The entity's accountant(s) should be notified of all contributions, distributions, and loans so that they are handled appropriately for tax reporting purposes.

DISTRIBUTING ASSETS OUT OF THE IEP

Discretionary distributions made to the client or other beneficiary from the trust (or out of the trust's interest in the partnership) should be made pursuant to the pertinent distribution standards set forth in the trust. As evidence that the IEP is being administered for the benefit of trust beneficiaries other than just the client, the trustees should consider making distributions for the direct benefit of the other beneficiaries, such as paying the college tuition of a child, making a charitable contribution to a charitable beneficiary, paying a beneficiary's medical expenses, and the like.

The assets owned within the IEP are not the client's personal assets; the client should avoid using the structure as his or her own "back pocketbook." Sufficient assets should be retained outside of the IEP so that normal day-to-day living expenses and reasonably anticipated obligations can be satisfied out of the client's earnings and retained assets. As a general rule, unprotected funds should be exhausted before a client requests a distribution from the trust or partnership. If after reviewing the client's other sources of income, however, distributions will be regularly required for the client's living expenses, such as for a retiree, the trustees may authorize periodic (e.g., quarterly) distributions for this purpose.

Proper documentation, however, usually in the form of a trust, partnership, or joint resolution, should be prepared for IEP distributions. For example, if partnership funds are to be distributed to the general partner/client, a joint partnership/trust resolution would document that the transaction will be treated as a 1 percent distribution to the client and a 99 percent distribution to the trust, followed by a distribution from the trust to the client as a beneficiary of the trust. Similarly, if the partnership will make a direct tax payment to the Internal Revenue Service on behalf of the client for income earned at the partnership level, a similar resolution should be prepared. If such transactions are not properly documented, a creditor could argue that the IEP should be disregarded, since it is being administered as nothing more than the client's "back pocketbook."

CONCLUSION

Administering the IEP's trust and limited partnership (and any other entity owned by the trust) in an arm's-length fashion, and carefully observing the fact that they are entities separate and apart from the client, are critically important to protecting the IEP's assets from any potential future creditor of the client. The client will typically spend

significant time and resources constructing a solid IEP. Through careful and thoughtful funding and administration, the client can also make sure that creditors will not gain access to the IEP's assets.

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