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Moving the Immovable: Protecting Real Estate From Creditors

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In most typical asset protection plans, the individual's assets are held in a family limited partnership (FLP) with the individual and/or his spouse as the 1 or 2% general partners and a foreign asset protection trust (APT) as the limited partner (usually with a 98 or 99% interest in the partnership). The usual APT is an irrevocable, self-settled spendthrift trust established in a jurisdiction that does not recognize foreign (e.g. U.S.) judgments, that has laws favoring such trusts, and that substantially limits the ability of creditors of the settlor to reach the assets in such a trust.¹ In the event of a creditor's attack, the FLP is liquidated and the assets are distributed to the partners according to the partnership shares, resulting in 98 or 99% of the assets suddenly appearing in the offshore trust. Purportedly the whole procedure takes only a day or two, so that by the time the creditor's attorneys are in court opening their briefcases, the debtor's funds are in a safe place.²

The problem with this typical scenario is that, from a practical standpoint, it is limited to "moveable" (i.e., liquid) assets – what this author refers to as "ready money", assets which conveniently lend themselves to quick liquidation and disappearance before the creditor's very eyes. But what about assets that are not so readily moveable, such as real estate?

The word for “real estate” in most European languages translates to “immovable” – an appropriate tag and the primary reason for the problems encountered in protecting such assets from a creditor’s attack. Even though there are methods that offer the appearance of protection through transfers to various types of entities (e.g., irrevocable trusts, limited partnerships, and corporations), the inescapable fact is that we have not really moved it. The property is still exactly where it was before the transfer, and unless the individual’s interest in the property was reduced by the transfer (and not the subject of a fraudulent conveyance), the property is still under the jurisdiction of the local court and consequently, subject to any orders, attachments, limitations, freezes, etc., the court may see fit to issue.

Accordingly, the question is, how do we protect the equity if not the property itself, from the reach of creditors? ³

The following discussion will briefly review some of the commonly used methods to accomplish this and then will focus on a method suggested by the author to be the most protective of the methods discussed.

Protection Through an Irrevocable Trust

As pointed out below, although it may be possible to gain creditor protection through a trust, the options are somewhat limited. It is common knowledge that, with the exception of a few states that have created statutory exceptions to the self-settled spendthrift trust rule⁴, a person cannot place his assets in a trust for his own benefit and at the same time protect those assets from his creditors.⁵ It is well settled that in such a case, the settlor’s creditors can reach the trust assets to the maximum extent they may be paid to the settlor under the terms of the trust.⁶

Even under these rules, however, it is possible for a settlor to gain some protection through a self-settled irrevocable trust. He could, for instance, establish a trust which provided only for payments of income to him, allowing discretionary principal payments only, say, to his spouse and children. In such a case, the settlor would typically reserve a special testamentary power of

appointment so as to avoid a completed gift⁷, and, absent fraudulent conveyance issues, the settlor's creditors could only reach the income; the principal of the trust would be protected. Note that this trust could also protect, in a sense, the income as well. That is, the trustee could make a distribution of principal to the beneficiaries (say, the settlor's spouse). The reduction or elimination of principal would, of course, result in a corresponding reduction or elimination of the income available to the settlor's creditors, but unfortunately, to the settlor, as well.

Another way to accomplish more or less the same result would be to give a third party, say the settlor's spouse or some other person close to the settlor but not a trust beneficiary, a broad special power to appoint the principal of the trust. This power could be utilized to remove the principal from the trust, perhaps to another trust, where the settlor was not a beneficiary. In fact, the power could be so exercised on a revocable basis, so that a later change in the family circumstances would allow for another exercise of the power, perhaps restoring the settlor's right to income.

Note that the settlor's original conveyance of the real estate to the trust is the transfer we must be concerned about for purposes of determining whether a fraudulent conveyance was made by the settlor. A later transfer by the trustee or by the exercise of power by a powerholder is not a conveyance by the settlor.⁸ Note also that, until the power is irrevocably exercised or released by a powerholder or released by the settlor, the settlor would continue to realize the income tax consequences of the ownership of the property, including losses attributable to depreciation.⁹

In effect, this approach allows the settlor to continue to substantially enjoy the benefits of his real estate, but protects it from his creditors. The problem is, his creditors can reach the income unless and until that is taken away from the creditor's reach by taking it away from the settlor, perhaps permanently. Not the best option. In order for the settlor to recover the income or any other benefits from the property, he must hope that one of the power holders would restore his interest in the future. Furthermore, there are some risky tax issues, such as a powerholder effecting a taxable gift "by" the settlor, by irrevocably exercising his lifetime power over the trust principal to a third party. Since the gift would then be complete, removing all dominion and control from the settlor, this would no doubt be treated as a completed gift by the settlor with

the attendant gift tax exposure. Considering that the property involved would most likely be of substantial value, this could be a serious concern. A possible way to avoid this exposure would be to require the settlor's consent to the exercise of the power, but the giving of such consent by the settlor would open the door to a creditor's claim of fraudulent conveyance by the settlor, so it should be avoided. Instead, the exercise could require the consent of another party, but it should not be an adverse party, as this could also have a significant bearing on the tax consequences to the settlor. That is, if the presence of the power is the factor which causes grantor trust treatment, requiring an adverse party to consent to its exercise would cause the settlor lose the income tax benefits offered by the real estate.¹⁰ As can be seen, the ramifications of the existence, exercise, and release of powers under different circumstances and conditions can be complicated and far-reaching, and should not be undertaken by the uninitiated.

The author is not unmindful of the possibility of simply transferring the real estate to a domestic self-settled asset protection trust in, say, Alaska, or one of the other states where such trusts are permitted by statute. The settlor would establish a trust naming himself as a discretionary beneficiary. Under the law of the particular state absent a fraudulent conveyance, the settlor's creditors could not reach the assets in the trust. The problem we see with this arrangement is that the real estate, presumably, is not situated in the state offering the protection. For instance, let's say we have a judgment creditor of a New York debtor who has New York real estate which has been "transferred" to an Alaskan trust. Does the creditor have to sue in Alaska or can he proceed "in rem" against the New York real estate? Of course, the debtor would argue that Alaskan law protects the trust asset, but how do you think a New York court would view it? And wouldn't the conflict of laws rules dictate that New York law should be applied?¹¹ A number of commentators have pointed out this and other problems, suggesting that the issue is unsettled at best.¹² Of course, it would be possible to add another legal layer to the picture by first transferring the real estate to a family limited partnership or limited liability company (see more discussion on this below), but the question remains whether this really solves the problem. After all, the real estate is still sitting just where we left it.

Protection Through Transfer to a Family Limited Partnership or Limited Liability Company

This is probably the most common method and in many cases, a reasonably good one, depending on the circumstances. Once the real estate is transferred to the FLP or LLC and fraudulent conveyance is not an issue, a creditor of a partner or member may only obtain a charging order against the entity.¹³ There is a growing concern among practitioners, however, that this age-old, solid protection may be changing.¹⁴ The basis of the protection was/is to prevent a creditor of a single partner from disrupting, if not endangering a going business of all the partners by seizing partnership assets to satisfy a debt that has nothing to do with the partnership business. Sounds fair enough. But how fair is it when the only partner is the debtor and the only “partnership assets” are cash and publicly traded securities? Where is the disruption? That is, in many typical asset protection cases the “debtor” is the general partner and his irrevocable APT (a grantor spendthrift trust) the limited partner. Will a court view this as a going business of partners that should not be disrupted? And where the only partnership assets are either a portfolio of securities or a couple of parcels of income-producing real estate, will a court view this as a going business that should be kept intact and not be available to satisfy a judgment held by a creditor of an individual partner? There is certainly a risk that a court may not see it that way or at the least may take a reactionary approach.

For instance, the author had this actual experience: client had numerous parcels of income-producing real estate worth several millions, set up in a labyrinthine series of partnerships and LLC’s, with the client, spouse, and various family trusts as partners and/or members. Client had personally guaranteed a debt of one of the entities, which fell in serious arrears. The creditor sued and attempted to attach all of the family real estate holdings. In reviewing the titles, entities, and complex overall arrangement, the court suggested that it would put all of the properties into receivership to give it time to “analyze this mess” and to discover “who owned what”, unless the parties could agree otherwise or settle the dispute.

Therefore, although the charging order protection may be substantial, there is clearly a question as to whether it can be unconditionally relied upon in any particular set of circumstances. Most seasoned litigators would agree that confronting a judge with the proposition that he is powerless to enforce a valid judgment (perhaps from his own court), because of the charging order rules, while at the same time seeing millions of dollars of immovable property within his judicial reach, is a challenge few debtors should want to face.

Protection By Leveraging the Asset

This method, which also can be quite effective, involves obtaining a loan for most of the equity in the property, then transferring the loan proceeds to an offshore APT. Of course, it assumes some very important basic circumstances. First, that the property is owned and controlled by the individual client. If there are other partners or joint owners who do not wish to use the plan it will not work. Second, that once the loan is obtained, transfer of the proceeds can be made without risk of attack as a fraudulent conveyance. In this regard, such loans are usually made after the property has been transferred to an FLP or LLC as discussed above, so that the date of the transfer for fraudulent conveyance purposes has previously been set. Therefore, if the property has already been in the FLP or LLC for the appropriate time, it is unlikely (though not impossible) that a subsequent transfer of the loan proceeds would be deemed a fraudulent conveyance.

The usual lender is an offshore bank affiliated with the offshore trustee. The bank will want an independent appraisal of the property as well as a mortgage deed to secure the loan and various other indemnification agreements. The loan proceeds must be placed in a certificate of deposit with the lending bank, and the CD is also pledged to secure payment of the loan. Typically, the offshore bank will lend up to 90 percent of the equity in the property, and the loan rate is designed to be extremely competitive, as is the rate paid on the CD, which is usually .5 percent above the bank's loan rate. This "profit", however, is taken up by the annual charges imposed by the bank for administering the loan. The usual net fee to the borrower is about 1 percent the first year and .5 percent annually thereafter. Legal fees for documents, recording, etc., and appraisal fees are, of course, in addition to this.

Once the loan is taken there is only the .5 percent net carrying costs, so the management of the property can go on as usual. An added benefit, however, is that in the event of a charging order the FLP can begin to make interest payments on the debt, which would reduce any distributions that may be subject to the charging order. At a future date (if ever) when the threat of a lawsuit is no longer a concern, the CD may be applied to liquidate the loan and the mortgage will be discharged.

A potential problem with this transaction is creditor exposure of the future appreciation of the property. That is, as the property appreciates in value (while the loan balance remains the same), there becomes more and more equity for a creditor to target. Although it is possible to attempt to monitor this and periodically secure additional loans to cover the appreciation, it can be difficult on a practical basis, as well as time consuming and expensive.

Protection Through an Intra-family Tax-Deferred Sale

This method involves a sale to a grantor trust¹⁵ and a subsequent transfer of the trustee's note to an APT.

It is well settled that for tax purposes an individual cannot make a sale to himself.¹⁶ It is also well-settled that if an individual retains certain powers or benefits over a trust, the trust will be ignored for income tax purposes (a so-called "grantor trust"), so that the individual rather than the trust will be treated as the taxpayer.¹⁷ Therefore, if an individual makes a sale of property to a grantor trust (where that individual is treated as the grantor) there will be no gain or loss recognized, although such a transaction will be recognized for purposes of property law, trust law, and the dispositive results of the transfer in all other respects. Here is how these characteristics can be applied to the protection of real estate.

Client has income-producing property valued at \$2 million, debt-free, and generating a net annual income of \$170,000. Client's adjusted basis in the property is \$400,000. Client establishes an irrevocable trust for the benefit of his children (alternatively, the beneficiaries

could be spouse and children or, of course, any other parties chosen by the settlor). The trust contains provisions which make it a grantor trust as to client, for tax purposes.¹⁸ Earlier, client had established an offshore APT for the benefit of himself and his spouse, with the usual estate planning provisions in the event of his death.¹⁹ Client and/or his spouse make gifts to the irrevocable grantor trust totaling about \$200,000, either presently or over more than one calendar year, filing gift tax returns accordingly.²⁰

The property is independently appraised and sold to the trust at the appraised price of \$2 million, in return for the trustee's negotiable promissory note in that amount, bearing interest at the lowest permissible rate.²¹ The note provides for payments of interest only for a period of years (say, 15 years) with a balloon payment on its due date.²² Once the sale is completed and title to the property is transferred to the trust, client assigns the promissory note to his APT. It is significant that although the transfer of the promissory note to the APT is subject to the fraudulent conveyance rules, the sale of the real property is not, because it is a transfer for adequate consideration. Therefore, the property (and its future appreciation) will be immediately moved beyond the reach of client's creditors once the sale is complete. And as explained above, client will recognize no gain or loss on the sale since the trust is a grantor trust, so that unlike the leveraging method, there is no tax on the transfer of the note to the APT.

Assuming the note calls for interest payments at 8 percent, the trust will make payments of \$160,000 per year to the APT. Note that these payments are due and payable to the APT and not to client, as he has transferred the note to the APT just after the sale. Accordingly, once the fraudulent conveyance exposure on the note transfer has passed, the interest payments as well are free from creditor's attack.²³ In addition, the payments are not taxable as interest to client, as the sale is not recognized for tax purposes. Client would continue to enjoy the tax benefits of ownership of the real estate.

This method also has the considerable added advantage (over all of the previous methods discussed) of freezing the value of the real estate for estate tax purposes. Since the property was transferred for valid consideration, and since the trust assets are excluded from the client's estate, only the value of the unpaid note will be included in his estate. The other side of this coin,

however, is that the trust receives the property with the grantor's adjusted basis, and a capital gain will likely result on a sale by the trust after the grantor's death.

Conclusion

The most significant feature of a solid asset protection plan – the moving of assets to a legal jurisdiction not readily accessible to creditors and decidedly unreceptive to them – is simply not available for real estate. Nevertheless, there are a number of methods, whether used alone or in combination with one another, that can provide a wall of protection designed to withstand a creditor's attack.

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¹ Typical jurisdictions having these characteristics include the Cook Islands and the Bahamas. Note also, that foreign trusts (IRC §7701(a)(30) and (31)(B), their settlors, and beneficiaries are subject to strict U.S. reporting requirements (IRC §6048, IRC Notice 97-34). Alternatively, a domestic APT may be used to avoid the IRS filing requirements of a foreign trust. When trouble strikes, the domestic APT converts to a foreign APT.

² This assumes there has been no fraudulent conveyance since the assets were transferred to the FLP sufficiently prior to the creditor's claim.

³ The discussion primarily contemplates income – producing and investment real estate as the assets to be protected, as opposed to the principal residence, per se.

⁴ Alaska, Delaware, Nevada, Rhode Island, and to a certain extent Missouri and Colorado.

⁵ Restatement Second Trusts §156

⁶ *Outwin v Commissioner*, 76 Tax Court 153 (1981)

⁷ Treas. Reg. 25.2511-2 (b)

⁸ Restatement Second Property §11.1, Comment f. Examples.

⁹ IRC §671

¹⁰ IRC §674

¹¹ *In re Portnoy*, 201 B.R. 685 (S.D.N.Y. 1996)

¹² See e.g., Giordani & Osborne, *Will The Alaskan Trust Work?* 3 Journal of Asset Protection 1 (Sept/Oct 1997).

¹³ Rev. Unif. Ltd. Partnership Act §§702, 703

¹⁴ *Crocker Nat'l Bank v. Perroton*, 208 Cal App 3d (1989) and *Madison Hills Ltd. Partnership v. Madison Hills, Inc.*, 35 Conn. App. 81 (1994)

¹⁵ An irrevocable trust designed to be excluded from the settlor's estate but nevertheless treated as a "grantor" trust for income tax purposes during the settlor's lifetime, under IRC §§671-677.

¹⁶ Rev. Rul. 85-13

¹⁷ IRC § 671

¹⁸ IRC §§677, 674, 675 (4) (c)

¹⁹ See, Alexander A. Bove, Jr. and Marjorie Suisman, *Coordinating an Asset Protection Plan with an Estate Plan*, *Asset Protection Journal*, Autumn 1999. Note also, that many commentators believe that upon the settlor's death, IRC section 684 would operate to cause gain recognition on appreciated assets in the APT, on the basis that the APT ceases to be a grantor trust at that time. If this is a concern, the APT should contain a provision giving the domestic irrevocable trust a power of withdrawal over the corpus of the APT on the settlor's death.

²⁰ Most (but not all) commentators agree that the grantor trust should be funded with an amount equal to about 10 percent of the value of the asset to be added to the trust. This supports the concept that the trust has the ability to make payments on the note independent of the property itself and that the transferor has not retained the equivalent of the income from the transferred asset (IRC §2036). As to the source of this funding, it could be by gift or by contributions from the beneficiaries themselves. There is no rule that the funding must be simultaneous with the sale but it certainly should be reasonably proximate.

²¹ IRC §1274

²² The term of the note depends upon the circumstances of the parties, the client's objectives with respect to the real estate, and the client's projected cash flow needs.

²³ This exposure could range from zero to four years, depending on the circumstances of the transfer, the creditor's claim, and the law applied. If the APT were subject to Gibraltar law, for instance, and the transfer did not render the client insolvent, protection would be immediate. IF US law is applied, the period is generally four years.