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Estate Planning & Administration Group

UPDATE

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# Introduction To Asset Protection Planning

*Asset protection planning — an important part of overall estate planning.*

Many clients express an interest in asset protection. This is not surprising given today's increasing litigious environment. Recent news of significant judgements against business and financial professionals and the limitations contained in the new "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005" make this a timely topic. This newsletter will discuss different asset protection techniques, the potential benefits, and the factors to consider in choosing among various options.

The words "asset protection", often connote exotic techniques such as a trust in a remote offshore locale. In fact, asset protection is much broader in scope. Many traditional estate planning arrangements help insulate assets from claims. In addition, some investments are beneficial from an asset protection standpoint. The more advanced techniques, such as offshore trusts, can provide the unique dual benefit of protecting assets from future creditors while still retaining access to the property. However, promoters frequently over-sell and misrepresent the protection those trusts provide. For those who

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can afford them, they are perhaps best used as a way to create a "disaster fund" — something to fall back on if there is a devastating financial event.

This is one of the basic principles to keep in mind when considering asset protection: fundamentally, it is about providing a nest egg to fall back on. It is rarely effective to completely insulate all assets from creditors. Indeed, many asset protection techniques are more about making assets unattractive, or difficult for a creditor to pursue (rather than impossible), with the ultimate goal of promoting a favorable settlement. Finally, and most importantly, planning has to be done in advance to stand the best chance of working. If a lawsuit has been filed, a claim already exists, or the proposed transfer would make you insolvent, any transfers of assets you initiate likely will be invalidated.

## Traditional Asset Protection Methods

*Just give it away — outright gifts of property to the right people — if done right.*

Outright Gifts are a simple way for you to protect your assets from future claims. Assets that you give away to your spouse or children are no longer subject to seizure by your creditors.

A transfer of property by gift does not necessarily entail a loss of control or loss of use of the property. There are several ways that you can indirectly retain benefits from the property. For instance, outright gifts between a husband and wife allow the donor spouse to continue to have input regarding investments and to benefit from the asset — so long as the spouses are on good terms, of course. In addition, no gift tax will be incurred because of the unlimited marital deduction for lifetime transfers between spouses.

> Example:
> Husband, a surgeon concerned about potential future malpractice claims, transfers assets to his spouse, who is not in a high-risk occupation. The transfers include his interest in their residence, as well as all stocks and bonds. There are no claims outstanding against Husband when he makes the claim and no then outstanding circumstances which would support a claim. This will protect the assets against the claims of Husband's future creditors. The couple still has unrestricted access to, and use of, the property.

*Trust in trusts can be well placed.*

Transfers in trust may be the most important, regularly used and accepted asset protection tool available. A gift to a trust can address concerns about the beneficiary's imprudent use of the property. In the case of a transfer to a spouse, a trust will provide some protection in case of later divorce.

> Example:
> Husband, a surgeon concerned about potential malpractice claims that could arise from his future medical practice, wants to transfer assets out of his name, but is concerned about the possibility of a later divorce. Husband transfers $1 million to an irrevocable family trust for Wife and children. Wife is trustee and can distribute property to herself and the children for health and support and to the children for their education. The family trust provides that if Husband and Wife divorce, then Wife automatically ceases to be trustee and all her interests in the trust terminate. The gift does not generate gift tax because it is covered by the $1 million lifetime exemption amount.

Husband also could use a lifetime QTIP trust to transfer property to Wife. A QTIP trust is a trust for the sole benefit of the spouse during his or her life. Transfers to the trust qualify for the marital deduction, so unlimited amounts can be transferred to the trust without gift taxes. The possible drawback of a QTIP trust is that the donee spouse must receive all the income for life, even if there is a divorce. However, the QTIP trust also has a unique advantage, because it is possible to make the spouse who created the trust (the donor spouse) a beneficiary of the trust if the donee spouse dies first. The resulting beneficial interest of the donor spouse likely will be protected from creditors.

> Example:
> Husband transfers $1,000,000 to a lifetime QTIP trust for Wife. Wife has a testamentary power of appointment. If she fails to exercise the power, the trust property will be held in trust at her death for the couple's children. Wife exercises the power in her will to provide that if Husband survives her, the

property will be allocated between a marital trust and credit shelter trust for Husband, to make optimal use of the marital deduction and applicable exclusion amount. The trust property should not be reachable by Husband's creditors, either before or after Wife's death.

Of even greater importance is the creditor protection that a trust provides to the trust beneficiaries. In most states, a beneficiary's creditors cannot reach trust assets if the ability to receive distributions of trust assets is subject to the trustee's discretion and the trust has, in good faith, been created by a person other than the beneficiary.

The significance of this potential creditor protection cannot be overstated. Anyone who is leaving property to children should consider the creditor protection benefits of leaving the property in trust for the children's lives. The trusts can be structured to give each child extensive control over his or her inheritance, while still providing the invaluable benefit of insulation from creditors. The child may be trustee of his or her own trust. Property may be distributed to the child and his or her descendants for health, education and support. The child may have a broad testamentary power of appointment that allows the child to appoint the trust property to anyone except the child, his or her estate or the creditors of either.

An often overlooked aspect of asset protection planning is the planning that your parents or other relatives can do for you. If you expect to inherit from your parents, and are concerned about asset protection, you should ask your parents to leave the inheritance in trust, not outright.

### *Togetherness can help keep your assets together.*

Different forms of co-ownership, such as tenancy by the entirety, joint tenancy with right of survivorship, and tenancy in common, provide different degrees of protection against creditors.

**Tenancy by the Entirety** is a special type of joint tenancy, between a husband and wife. Under common law, a tenancy by the entirety was not severable by the husband or wife. In states which follow the common law rule, consequently, the creditor of one spouse cannot seize or obtain a lien on property held in tenancy by the entirety. The protection afforded by a tenancy by the entirety is not permanent. Instead it only lasts as long as both spouses are alive and married to each other. It provides no protection for liabilities that are joint obligation of both spouses, such as family health and support debts.

**Joint Tenancy with Right of Survivorship** provides only minimal protection. The creditor of one tenant can reach that tenant's fractional interest at any time during the joint tenancy. However, if the debtor tenant dies before the creditor has perfected his or her interest in the property, the surviving tenant normally will become owner of all the property free from the creditor's claim.

**Tenancy in Common** provides even less protection than a joint tenancy. A creditor of a co-tenant can reach the debtor's undivided fractional interest, and, since survivorship is not an element of tenancy in common, the death of the debtor tenant will not prevent a creditor from reaching that tenant's interest.

### *Untouchables — certain assets ("exempt assets") are not subject to claims by creditors.*

Here are some of the most important ones:

Personal Residence — separate and apart from the protection of a tenancy by the entirety arrangement, most states have a homestead exemption that allows an individual to always retain a certain amount of equity in their residence. In many states, the exemption is limited; for example, in Illinois, it is $7,500. Florida and Texas, however, have homestead exemptions that allow residents to retain all the equity in their home and adjacent land, subject to certain size (but not value) limitations. Florida allows a homestead exemption for properties of up to 160 acres outside a municipality, and up to one-half acre inside a municipality. Texas has a rural homestead exemption for up to 200 acres for a family, 100 acres for a single person; and an urban homestead exemption for up to one acre. New York has a personal residence exemption of $10,000 for an individual and $20,000 for a husband and wife.

The new bankruptcy legislation limits the use of the higher state homestead exemption in bankruptcy if the debtor has been in the home less than three years and four months. The limit also will apply, regardless of length of occupancy, if the debtor's obligations arise from securities law violations or certain other criminal acts. Remember that the bankruptcy limitations only apply if a person declares bankruptcy or the person's creditors force it upon him or her.

Life Insurance — Many states exempt life insurance and annuity contract proceeds or cash value or both from the reach of creditors. In some states, such as Illinois, the exemption is available only if the insurance is payable to a member of the immediate family or other dependent. In New York insurance proceeds payable to anyone (not just family) are exempt from the creditors of the insured.

Variable life insurance policies and variable annuity contracts can have a significant investment element. In fact, they frequently are sold as an alternative investment vehicle, with the insured/annuitant being able to invest in a number of mutual funds inside the policy or contract. Thus, you can use an investment-oriented insurance policy as an alternative to transferring property in trust.

> Example:
> Stan will be entering into a risky business venture in the near future. He liquidates $1,000,000 of his investment portfolio and invests it in a variable life insurance policy that offers investment of cash value in a selection of mutual funds. Over 15 years, the value of the policy grows to $2,750,000. This property should be exempt from the reach of any future creditors of Stan. After his retirement, Stan could start drawing on the cash value of the policy, either by borrowing or direct withdrawals of cash value.

Retirement Plans — Both ERISA and the laws of many states protect qualified retirement plans from creditors. Individual retirement accounts are not subject to the ERISA protections, but are protected under the laws of many states. In addition, under federal bankruptcy laws, age based retirement accounts are protected assets. The U.S. Supreme Court recently ruled that IRAs also are entitled to this protection in a bankruptcy. One simple asset protection step for a person in a high-risk profession is to take maximum advantage of opportunities to contribute to qualified retirement plans and IRAs. The new bankruptcy legislation will limit the IRA protected amount to $1,000,000 in certain circumstances.

The use of exempt assets to preserve one's wealth can be extremely effective. In 1988, former Treasury Secretary John Connolly was forced to seek bankruptcy protection. Under Texas law, 200 acres of his ranch, the ranch headquarters, retirement benefits, and life insurance policies were exempt from the claims of creditors. As a result, Connolly exited bankruptcy with a net worth in excess of $3 million.

# Family Limited Partnerships and Limited Liability Companies

*Keeping some of it in the family can help keep it away from creditors.*

The Family Owned Limited Partnership and Limited Liability Company have become popular vehicles for managing and controlling family assets. A typical family partnership is a limited partnership with one or more general partners and limited partners. The family partnership provides a number of benefits, both tax and non-tax, including valuation discounts, transfers of value without relinquishing control, and restrictions on further transfer of limited partnership interests. Almost identical benefits can be found with limited liability companies which have members with limited liability rather than limited partners.

A limited partner's personal exposure for the debts of the partnership (or LLC) is generally limited to his investment in the partnership. This prevents a creditor of the partnership from reaching the personal assets of a limited partner to satisfy debts owed by the partnership.

*What's a "charging order," and how does it protect assets?*

A limited partnership or LLC also can provide some (but not complete) creditor protection against creditors of a partner. Usually, the sole remedy provided to creditors with respect to a debtor's interest in a limited partnership (or LLC) is a charging order. Typically, a creditor can use a charging order to claim the distributions to which the debtor partner would have been entitled but only those distributions, which would have been distributed to the debtor partner. The assets retained in the partnership or LLC generally cannot be reached.

The family can enhance the creditor protection by including provisions in the partnership agreement that trigger repurchase options when a partner's interest becomes subject to a charging order or that partner declares bankruptcy. Typically, the purchase options are at a deep discount from the net asset value of the partnership interest. This allows the partnership to take the creditor out of the picture entirely, while preserving the underlying partnership assets to the maximum extent possible. Of course, this leaves the debtor family member without an interest in the partnership. However, because

the family has been able to preserve a greater share of the partnership property, other family members may be able to restore part of the debtor's interest through gifts after the creditor problems have passed.

*Charging orders also can be too taxing on creditors.*

The tax treatment of a charging order also may discourage a creditor from acquiring a debtor's interest in a limited partnership. Many tax practitioners believe that the income tax effect of a charging order is to cause the creditor to be liable for tax on the partnership income, even if no distributions actually are made by the partnership (also known as "phantom income"). Because of these issues, the creditor may accept a settlement favorable to the debtor.

## Offshore Protection Trusts

*One of the most talked about estate planning techniques in recent years.*

They are heavily promoted as effective barriers against claims of creditors because the laws of most offshore trust havens make it difficult for creditors to obtain jurisdiction over, or levy against, a trust, even if the settlor retains an interest in the trust property. Unlike most states of the United States, a number of foreign jurisdictions permit a settlor to create a spendthrift trust for his or her own benefit. These barriers often insulate the property entirely from creditors, or produce early and inexpensive settlements.

An Offshore Protection Trust can create geographic, legal, procedural, and financial hurdles to reaching its assets. The mere fact that a trust is a foreign trust may deter creditors from pursuing the trust. This is particularly likely if the trust is funded with assets from the foreign jurisdiction. The cost of pursuing a claim against a foreign trust can be high, especially since foreign jurisdictions may prohibit contingent fee litigation or require significant deposits to commence a proceeding. Some jurisdictions, such as the Cook Islands, do not recognize foreign judgments. Thus, an action first brought in a United States court may have to be tried all over in a foreign jurisdiction. As mentioned, many foreign jurisdictions have favorable spendthrift trust provisions that protect the interests of a settlor-beneficiary. Such provisions are in contrast to dominant rule in the United States that one may not create a spendthrift trust for one's own benefit.

Offshore Protection Trusts are now quite popular among wealthy families, investment managers and professionals, such as doctors, lawyers, and accountants, as a way to shield assets from professional liability claims.

Current estimates indicate that $1 trillion worth of assets are held in Offshore Protection Trusts. However, there is no estimate as to how much of this total consists of U.S. source assets.

*Provisions of Offshore Protection Trusts generally include the following:*

Governing Law — The trust is created and governed under the laws of one of several foreign jurisdictions that have laws favorable to Offshore Protection Trusts. These include among others: (i) the Cook Islands; (ii) the Cayman Islands; (iii) Gibraltar; (iv) the Isle of Man; (v) the Bahamas; (vi) Belize; (vii) the Turk and Caicos Islands; (viii) Cyprus; and (ix) Nevis.

Irrevocability — The trust is irrevocable; however, as *described* below, there is usually a substantial power of amendment vested in a third party.

Term — The trust may have a term for a set number of years or last for the life of the settlor or one or more beneficiaries.

Beneficiaries — The beneficiaries normally include the settlor and one or more family members.

Trustees — A trustee located in the jurisdiction is almost always required. Typically, this is a foreign corporation with trust powers. It may be possible to have one or more U.S. co-trustees, but this increases the risk of attachment by creditors since a U.S. trustee is potentially within the jurisdiction of U.S. courts.

Distributions — A foreign trustee usually has unfettered and absolute discretion over the distribution of income and principal.

Control — The settlor often retains some degree of control over the trust through: (i) Membership in or designation of a committee of advisors, with powers similar to those of a "trust protector," described below; (ii) Retaining limited authority to take steps such as removing trustees and appointing new trustees; or (iii) Designating a "trust protector" with authority to make more substantial changes to the trust, such as moving the trust to another

jurisdiction, or terminating a beneficiary's interests.

Typically, the degree of control that a settlor retains bears an inverse relationship to the amount of creditor protection that the trust provides. In other words, the more control that a settlor is willing to relinquish, the greater asset protection he or she generally will achieve. Conversely, if a settlor retains too much control, he or she runs the risk of having the entire arrangement overturned by a court as a "sham transaction."

### *Funding an Offshore Protection Trust*

One method of funding an Offshore Protection Trust is to transfer interests in a U.S. family limited partnership, LLC or other domestic legal entity. The idea is that while the underlying asset is physically situated in the United States, the foreign trust law has been imported to protect the interests. Although it may be possible to "export" the underlying assets at a later time, there is a risk with this approach that a U.S. court will freeze the assets before they can be moved.

Some commentators argue for placing as much of the client's assets as possible in a U.S. family limited partnership, and putting 99% of the limited partnership interests into an offshore trust. This technique combines the protection afforded by partnerships with the protection afforded by offshore trusts. The intent would be that once a possible claim surfaced, the foreign trustee would have the power under the trust agreement to remove any domestic trustee (to protect them from any potential court order) and, as majority limited partner, to liquidate the partnership and move the assets offshore to protect against creditors.

Other commentators argue for placing only a limited percentage of one's assets in an Offshore Protection Trust and using assets that are physically located in the foreign jurisdiction to fund the trust. Such an approach, especially if coupled with well-documented reasons other than, or in addition to, asset protection, arguably is less likely to give rise to allegations of a fraudulent conveyance than placing all of one's assets in the Offshore Protection Trust because, when a limited percentage of the total assets is used, the client could pass a solvency test after the creation and funding of the offshore trust.

Although an Offshore Protection Trust may be funded with any amount of assets, typically it should be funded with at least $1 million of assets to justify the expenses of creating and administering the trust.

### *The Cost of Offshore Protection Trusts*

The creation and maintenance of an Offshore Protection Trust can be quite expensive. Typically, the settlor will have to engage a U.S. accountant, U.S. attorney, foreign attorney, and foreign trustee. In some cases, the settlor may also have to engage a trust protector, an investment advisor, and a foreign custodian banker. In addition, the settlor should be prepared to pay some local taxes and registration charges and a variety of fees. In sum, the initial cost of implementing an Offshore Protection Trust may range from $10,000-$15,000 at the low end to in excess of $100,000 in the high end, and there will be annual maintenance costs on top of the cost of initial creation.

Impact of recent cases — some taxpayers who have established Offshore Protection Trusts are beginning to discover that they do not always provide the level of creditor protection advertised. The fundamental problem is that a U.S. resident who moves assets to an offshore trust is still personally subject to the jurisdiction of U.S. courts. As in a recent Florida bankruptcy case, *In re Lawrence*, the court may have little sympathy for someone who has, in its view, "stashed" funds offshore. In that case and others, courts have been quite willing to hold a debtor in contempt of court, and place them in jail, for not trying sufficiently hard to satisfy a judgment.  However, these cases usually involve limitations where the person obtained the assets used to fund the trusts less than honestly.

## Domestic Protection Trusts

### *The current state (or rather, states) of Domestic Protection Trusts.*

In 1986, Missouri amended its spendthrift statute to become the first state to permit settlors of trusts to obtain spendthrift protection if the transfer to the trust was not fraudulent. Its law was strengthened in 2004.

In 1997, Alaska and Delaware enacted legislation to permit the settlors of a trust to remain a trust beneficiary, but still obtain spendthrift protection. Proponents of the Alaska and Delaware statutes assert that they offer the same opportunity to protect one's assets from creditors that is otherwise available only with offshore trusts created in certain debtor friendly jurisdictions.

In 1999, Nevada and Rhode Island enacted similar legislation.

In 2003, Utah enacted legislation to permit the settler of a trust to obtain spendthrift protection as a beneficiary, but only with respect to personal property transferred to the trust. South Dakota enacted its own asset protection law, which is based on Delaware's law, effective July 1, 2005.

Oklahoma has a strange version for asset protection legislation that was enacted in 2004 and while it does not provide protection to the creator of a trust, it permits the creator to revoke the trust at any time, while protecting $1 million of Oklahoma assets held for the benefit of a spouse, children, grandchildren, and charity.

Each state has somewhat different requirements for an effective domestic protection trust. However, each has the same basic requirements:

- The trust must be irrevocable (except the new Oklahoma statute).
- Creator of trust can be a discretionary beneficiary of the trust but must not be entitled to mandatory distributions
- At least one of the trustees must be a citizen of the state or a corporate fiduciary based in the domestic protection state (except Missouri).
- Some of the administration of the trust must take place in the domestic protection state
- Some of the assets must be held in the domestic protection state.

There have been no cases to date challenging the validity of domestic asset protection trusts. That leaves some uncertainty as to their effectiveness. At the same time, the lack of challenges after 7+ years suggests that creditors believe them to be effective. As with other transfers to provide asset protection, the transfer cannot be a fraudulent transfer. In addition, the new bankruptcy legislation creates additional hurdles that must be cleared before a self settled asset protection trust (whether domestic or foreign) can be relied upon. In particular, if a transfer is made to such a trust within 10 years of the filing of a bankruptcy petition with an intent to hinder or avoid any present or future creditor, then the bankruptcy trustee could void the transfer.

Domestic asset protection trusts also can help in planning to offset estate taxes at death and gift taxes during life. Several commentators have taken the position that if creditors cannot reach the trust property, as will be the case if the Missouri, Alaska, Delaware, Nevada, Rhode Island, Utah, and South Dakota acts prove effective, the trust property will not be includible in the settlor's gross estate, even though the settlor is a discretionary beneficiary of the trust. Instead, a completed gift will occur upon the transfer of the property to the trust.

Example:
"Q" creates a Domestic Protection Trust in Alaska in 2005 and funds it with $1 million, the amount that can pass free of gift tax during life. "Q" and his children are discretionary beneficiaries of the trust. Because creditors cannot reach the assets in the trust, the gift is complete and the assets are not included in "Q's" estate. "Q" dies in 2015 when the assets in the trust are worth $5 million. Up until the time of his death, "Q" has been a discretionary beneficiary and received distributions from the trust. By using a Domestic Protection Trust, the $4 million of appreciation after funding of the trust will escape estate taxation.

Final note — while the costs to create and maintain a domestic asset protection trust are less than the cost of an offshore trust, the costs are not insignificant.

## Conclusion

Asset protection should be a part of the regular estate planning process. As this update indicates, there are many techniques, ranging from simple to complex, that can be employed. The Schiff Hardin Estate Planning and Administration Group is well-versed in the advantages and disadvantages of asset protection strategies.

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