

ASSET PROTECTION PLANNING – A PRIMER

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I. WHAT IS ASSET PROTECTION PLANNING?

A. Estate Planning. Structuring financial affairs to minimize the burden of future (unforeseen, unintended) liabilities.

B. Why Plan?

1. Richard Neeley--Chief Justice of the West Virginia Supreme Court:

"As long as I am allowed to redistribute wealth from out-of-state defendants to injured in-state plaintiffs, I will continue to do so. Not only is my sleep at night enhanced, but so is my job security as the resident plaintiffs, their families and friends will tend to reelect me."

a. Examples.

i. New York City man who sued the city after a failed suicide attempt because the operator of the subway train he jumped in front of did not stop in time.

Judgment: \$750,000

ii. Texas rancher who sued a pharmaceutical company after his Mexican ranch hands poisoned his prize bull because the medication bottle only had toxicity warning written in English.

Judgment: \$8,500,000.

2. Insurance. Some lawsuits will not be covered by insurance. For example, insurance policies generally do not cover intentional acts such as:

- a. misrepresentation,
- b. fraud,
- c. conspiracy,
- d. deceit,
- e. theft;
- f. conversion,
- g. wrongful termination, and
- h. sexual harassment.

II. GOALS (LIMITED).

- A. Increase the safety of your clients' assets.
- B. Create a climate which is conducive to a favorable settlement.
Note: You cannot hide or "shield" assets.

III. BASIC STRATEGIES.

- Lower profile.
- Go "bare."
- Bankruptcy???

A. Lowering Your Financial Profile.

1. Examples.

- a. Trust with a fictitious name, and a trustee who is not obviously identified with the trustor ("land trust");
- b. Limited partnership with a corporate general partner;
- c. Limited liability company ("LLC");
- d. Marital property agreements;
- e. Generation-skipping transfers;
- f. Qualified plan benefits;
- g. Testamentary planning for surviving spouse.

2. Problem With Relying Only on a Lower Profile. No protection if the creditor or his or her lawyer asks the right questions.

B. Going Bare.

1. Can a Client Evade Current Creditors? Not if they come from the courthouse because the jury is out--too late!!! A transfer taken to avoid, evade or delay a current creditor:

- a. is a "fraudulent transfer";
- b. can be reversed by a judge;
- c. can result in criminal penalties (see Penal Code § 154); and
- d. can cause any professional (CPA or lawyer) helping them to lose his or her license to practice.

2. What is a "Fraudulent Transfer"?

A transfer made or obligation incurred . . . is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the transferor made the transfer or incurred the obligation . . . :

[Actual Fraud]

With actual intent to hinder, delay, or defraud any creditor . . .

or:

[Constructive Fraud]

Without receiving a reasonably equivalent value in exchange for the transfer or obligation,

and:

was engaged or was about to engage in a business or a transaction for which the transferor's remaining assets . . . were unreasonably small in relation to the business or transaction, or

Intended to incur, or believed or reasonably should have believed that the transferor would incur, debts beyond the transferor's ability to pay as they became due.

3. Is a Fraudulent Transfer a Crime? Yes. California Penal Code Section 154 provides that:

“(a) Every debtor who fraudulently removes his or her property or effects out of this state, or who fraudulently sells, conveys, assigns or conceals his or her property with intent to defraud, hinder or delay his or her creditors of their rights, claims, or demands, is punishable by imprisonment in the county jail not exceeding one year, or by fine not exceeding one thousand dollars (\$1,000), or by both that fine and imprisonment.

“(b) Where the property so removed, sold, conveyed, assigned, or concealed consists of a stock in trade or a part thereof, of a value exceeding one hundred dollars (\$100), the offense shall be a felony and punishable as such.”

IV. WHAT ARE PROPER REASONS TO TRANSFER ASSETS?

- Motives unrelated to hindering creditors; and
- To take advantage of statutory exemptions from judgments.

A. Motives Unrelated to Creditors.

1. Income Tax Planning. Income tax savings may be achieved if, for example, your client diverts income to your client's children or a trust for their benefit.

2. Business Planning. Your client might be well advised to divide an existing business into separate corporations so assets of one are not subject to another's liabilities.

3. Estate Planning. Assets owned by a trust for the trustor's children can be excluded from the trustor's taxable estate.

4. Pre-Divorce Planning. Couples with marital problems sometimes enter into agreements providing how their property will be divided in the event of a divorce or death.

5. Divorce. Family Code Section 916(a) protects transfers made as part of the division of property in connection with a divorce from creditors:

“(2) The separate property owned by a married person at the time of the division and the property received by the person in the division is not liable for a debt incurred by the person's spouse before or during marriage, and the person is not personally liable for the debt, unless the debt was assigned for payment by the person in the division of the property . . .

“(3) . . . if a money judgment for the debt is entered after the division, the property is not subject to enforcement of the judgment and the judgment may not be enforced against the married person, unless the person is made a party to the judgment for the purpose of this paragraph.”

Query: If this provides an incentive to get divorced (to protect property from creditors), could the transfer be viewed as fraudulent for federal bankruptcy purposes?

6. Medi-Cal Planning. Trusts designed to make clients eligible for Medi-Cal benefits also often protect assets from frivolous lawsuits.

B. Pre-Bankruptcy Planning to Take Advantage of Statutory Exemptions.

1. Generally consists of converting assets that creditors can reach into assets that creditors cannot reach.

a. Two issues:

i. Whether the Bankruptcy Court will validate the transfers and allow one to keep the exempt assets;

ii. Whether the Bankruptcy Court will allow a debtor to discharge debt when the debtor has engaged in pre-bankruptcy planning.

b. Avoidance of Transfers.

i. The more time which elapses between (i) the transfer of non-exempt assets into exempt assets and (ii) the filing of the bankruptcy proceeding, the more likely it will be that the transfer will be upheld.

(a) If planning has occurred more than one year before you are forced to seek bankruptcy, then the debtor will generally be accorded a discharge.

ii. Pre-bankruptcy planning which is engaged in on the eve of filing bankruptcy may result in a double loss:

(a) Assets will not be protected because the court will allow them to be recovered as a "fraudulent conveyance"; and

(b) The debtor will not be permitted to discharge debt for having engaged in actions with intent to hinder, delay or defraud creditors.

iii. Even though the Bankruptcy Court may permit a debtor to discharge debt, a court may not permit the debtor to keep the assets.

(a) Transfers of property may be avoided under two separate laws: (i) the Uniform Fraudulent Conveyances Act ("UFCA") and (ii) the Bankruptcy Code. These laws are applicable to transfers made to protect assets and in contemplation of bankruptcy including gifts, conveyances of property into trusts, and bargain sales.

(b) One of the keys for pre-bankruptcy planning is to plan ownership of assets long before there is any need for a bankruptcy filing. Neither the Bankruptcy Code nor the UFCA prohibit asset planning so long as, after the assets have been transferred, the debtor is "solvent."

(c) In determining solvency, the courts look to what the fair market value of the remaining assets is versus the expected liabilities at the time of the completion of the transfers.

(1) A debtor is insolvent under the UFCA when the "fair market value" of his assets is less than the debtor's probable liabilities.

(2) The Bankruptcy Code uses a balance sheet approach to solvency.

i) In determining what the debtor's assets are, you must include their fair saleable value at the time.

ii) In determining liabilities, the probability of a liability must be determined in order to arrive at a present value for the liability. If the liability is unlikely to occur, then the amount of the liability will be nominal.

c. Grounds for Denials of Discharge.

i. Section 727(a)(2)(A) of the Bankruptcy Code—"The court shall grant an individual debtor a discharge unless the debtor, with intent to hinder, delay or defraud a creditor, has transferred, removed, destroyed, mutilated, or concealed assets within one year before the date of the filing of the petition."

(a) Courts will deny a discharge based upon the debtor's engagement in "sharp dealing" just prior to filing bankruptcy. "Sharp dealing" can include misrepresentation of the facts to the creditors, lack of disclosure (even where affirmative misrepresentation has not occurred), and underhanded activities directed towards creditors.

C. What are the Exemptions from Judgments?

1. Most are Small.

- a. \$2,300 equity in a motor vehicle (Code Civ. Proc. § 704.010);
- b. ordinary and reasonably necessary household furnishings, appliances and clothes (Code Civ. Proc. § 704.020);
- c. \$2,425 of material about to be applied to repair or improve the residence (Code Civ. Proc. § 704.030);
- d. \$6,075 of jewelry, heirlooms and art (Code Civ. Proc. § 704.040);
- e. health aids, including prosthetic appliances (Code Civ. Proc. § 704.050);
- f. \$6,075 of tools, uniforms, books, vehicles per spouse if reasonably necessary for the trade, business or profession (Code Civ. Proc. § 704.060);

- g. \$9,700 cash value of life insurance policies (Code Civ. Proc. § 704.100); and
- h. workers' compensation claims or awards (Code Civ. Proc. § 704.160).

2. Two exemptions--homesteads and private retirement plans--are potentially large.

a. Homesteads. Seventy-five thousand dollars (\$75,000) of equity in a married couple's home is exempt from judgment. That number rises to one hundred fifty thousand dollars (\$150,000) if either spouse is:

- i. 65 or older; or
- ii. disabled (Code Civ. Proc. § 704.730).

b. Private Retirement Benefits.

i. Three Types of Plans Exempt. California law exempts money held in or paid by a "private retirement plan" which is defined to include:

(1) private retirement plans, including, but not limited to, union retirement plans.

(2) profit-sharing plans designed and used for retirement purposes.

(3) self-employed retirement plans [Keoghs] and [IRAs] . . . to the extent the amounts . . . do not exceed the maximum amounts exempt from federal income taxation" (Code Civ. Proc. § 704.115(a).)

However, under California law Keoghs and IRAs are:

" . . . exempt only to the extent necessary to provide for [your client's] support . . . when [your client retires] and for the support of [your client's spouse] and dependents . . . taking into account all resources that are likely to be available for [your client's] support . . ." (Code Civ. Proc. § 704.115(e).)

(1) Contrast Federal Law. A Keogh is an ERISA plan and, therefore, in bankruptcy, completely exempt from creditors.

However, if the owner is not in bankruptcy, the Keogh is not protected by federal law.

ii. ERISA Compliance and Tax-Exempt Status Not Required for California Exemption. California's exemption is not restricted to plans qualifying under ERISA and the Internal Revenue Code.

iii. Contrast Federal Bankruptcy Law.

(a) Patterson v. Shumate. In June 1992, the U.S. Supreme Court decided that plans qualified under ERISA are exempt from creditors in a bankruptcy.

Therefore, normal profit-sharing, money purchase pension, 401(k), ESOP and defined benefit plans, whether or not sponsored by a corporation, are exempt.

(b) Planning Point re: Large Rollover IRAs. Advise clients with significant value in "rollover IRAs" to figure out a way to get the funds back into an ERISA type plan.

(1) Advise the client to incorporate a business (or hobby?) and have that corporation adopt a profit-sharing plan.

(2) Clients who already have corporations should adopt profit-sharing plans and directly transfer the funds from the rollover IRA into the profit-sharing plan.

V. FAMILY TRANSFERS.

A. Types.

1. Parents/Other Donors.

a. Generation Skipping Transfers.

- i. Save taxes.
- ii. Avoid creditors.

2. Community/Separate Property.

a. Marital Dissolution.

3. Testamentary Planning for Surviving Spouse.

- a. Use trusts to avoid creditors.

4. FLPs and FLLCs.

- a. Charging Order.
- b. K-1 income.

B. Drawbacks.

1. Assets/Transferees Remain Subject to Legal System. Creditors are able to attack donees as fraudulent transferees, as constructive trustees for the donors or on the basis that, following the transfer, the donors failed to cut the strings by retaining benefit and/or control.

a. Creditors may proceed with litigation against the donees.

2. Requires Losing Control Over Property. To have a chance of success, the donor must give away the property.

a. A gift may not be consistent with the client's other goals.

b. In the case of a gift to a spouse, consideration should be given to the consequences of a dissolution of the marriage.

c. In the case of a gift to a minor child, consideration should be given to whether the donor should be the custodian under applicable gifts to minors law.

d. Community assets are subject to the separate obligations of either spouse.

i. Accordingly, a common asset protection technique is to partition the community assets into separate property.

ii. By partitioning community property, the spouses lose the benefit of the double step-up in basis of the partitioned property otherwise available under IRC Section 1014(b)(6).

e. The donee may be subject to creditors' judgments.

3. Gift Taxes. A transfer by gift to one other than the spouse may result in a gift tax liability.

a. Gifts Between Spouses. If each spouse does not have at least \$2,000,000¹ in assets, the wealthier spouse can transfer such amount which results in the donee spouse's estate having value at least equal to the Unified Credit Amount. Gifts between spouses are not subject to gift tax.

b. Gifts to Children. Gifts can be outright or in trust.

i. IRC Section 2503(c) Minor's Trust: Requires principal to be distributed when child is 21 or, if child is not barred from getting the trust property, may remain in trust after age 21.

(a) Trust cannot be reached by donor's creditors;

(b) Trust cannot be reached by children's creditors until after child is 21.

¹ \$2,000,000 being the current United Credit Amount, which is scheduled to increase to \$3,500,000 in 2009; become unlimited in 2010; then fall back down to \$1,000,000 in 2011.

ii. IRC Section 2503(b) Minor's Trusts: Can last beyond a child's minority. Income must be distributed to child annually. Child's creditors cannot reach the principal.

4. Constructive Trust Doctrine. Constructive trusts may be imposed if transferor was insolvent at time of the transfers and they were made (i) without adequate consideration; or (ii) with intent to hinder, delay, or defraud creditors.

VI. CHARITABLE GIVING.

A. Charitable Remainder Trusts. One of the best ways to protect assets is to donate everything to charity and receive a lifetime annuity. If structured properly as either a charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT), the gift can create both income tax and estate tax savings while ensuring that the assets are no longer available to creditors.

1. Income Tax Benefits.

a. Charitable deductions equal to remainder interest.

i. Capital Gains tax exclusion--can use highly appreciated assets to donate and avoid capital gain tax.

2. Estate Tax Benefits.

i. Asset removed from estate at no transfer tax cost.

ii. Donor can purchase insurance policy for heirs to replenish wealth.

VII. FAMILY LIMITED PARTNERSHIPS ("FLPS") AND FAMILY LIMITED LIABILITY COMPANIES ("FLLCS").

FLPs and FLLCs can be of immense benefit in protecting assets from creditors as well as reducing estate taxes.

A. Features.

1. Generally formed without tax effects--IRC Section 721.
2. Provides limited liability to the limited partners or members.
3. General partners, managers or managing members, frequently the husband and/or wife, manage and direct the entity's affairs. General partners and managers can receive a salary.
4. Provides income tax benefits via income splitting.
5. Must be created pursuant to state statute.
6. Provide asset protection.

B. Formation and Operation. Assets are transferred to the partnership or LLC for a limited partner or member interest which may then be assigned to other family members. The general partner, manager or managing member (who can be the transferor of the assets) maintains control over the manner in which the assets are invested or managed and determines when distributions of income will be made.

C. Asset Protection Features. Most state laws protect the assets of the entity from the individual creditors of a limited partner or member and restrict the creditor's remedy to that of a charging order against the debtor's partnership or economic interest.

1. California Corporations Code Section 15671. Nature of Partnership Interest.

A partner has no interest in specific limited partnership property.

a. ULPA 2008 Section 15907.01. The only interest of a partner which is transferable is the partner's transferable interest. A transferable interest is personal property.

b. California Corporations Code Section 17300. Nature of LLC Interest. A member has no interest in specific LLC property.

2. California Corporations Code Section 15672. Assignment of Partnership Interest.

Unless otherwise provided in the partnership agreement:

- An assignment of a partnership interest does not dissolve a limited partnership or entitle the assignee to become or to exercise any rights or powers of a partner;
- An assignment entitles the assignee to share such profits and losses, to receive distribution or distributions and to receive such allocation of income, gain loss deduction or credit or similar item to which the assignor was entitled to the extent assigned.

a. ULPA 2008 Sections 15907.01 and 15907.02. Transfers of Transferrable Interests.

b. California Corporations Code Section 17301. Assignment of LLC Interests.

- i. Membership interests.
- ii. Economic interests.

3. California Corporations Code Section 15673. Rights of creditor of limited partner.

“On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee...”

- Effect of charging order is to give a creditor the mere right to receive the debtor limited partner's income, distributions of which may be in general partner's discretion.

- a. ULPA 2008 Section 15907.03. Judgments against transferees.
- b. California Corporations Code Section 17302. Judgments charged against LLC

interest; foreclosure.

4. Rev. Rul. 77-137--a creditor who obtains a charging order and an assignment of a limited partnership or LLC economic interest is treated as the partner for tax purposes and must report "phantom income" attributable to such interest.

D. Estate Planning Features. Senior members of the family may make gifts of partnership interests while still retaining control. If minority interests are transferred, substantial discounts should be available for estate tax purposes.

E. Disadvantages Re Asset Protection Planning.

1. Gift taxes will be incurred on all non-spousal gifts in excess of the sum of the annual exclusion amount plus the Unified Credit Amount. Gift tax returns will be required for all non-spousal gifts in excess of the Unified Credit Amount.

2. Client's ability to receive benefits from entity assets will be restricted if a creditor has a charging order.

3. Client remains subject to the domestic legal system.

VIII. TRUSTS.

A. Domestic Trusts.

1. Disadvantages:

a. Settlor must give up control and benefits to obtain creditor protection.

i. Creditors can reach a beneficiary's interest to satisfy their claims against that beneficiary.

ii. Creditors can also reach the assets of a trust in which the settlor retains rights to revoke or direct the distribution of assets.

iii. Potential target defendant.

iv. No jurisdictional/procedural hurdles/problems to overcome.

B. Alaska/Delaware Trusts.

C. Foreign Trusts.

1. Procedural/Other Barriers. A foreign trust affords procedural and other barriers which can impact a creditor's decision to pursue claims against trust assets. Three bodies of law are necessarily involved:

- a. Law of the selected jurisdiction (i.e., choice of law).
- b. Local/domestic law relating to creditors' rights.
- c. Federal tax law.

2. Choice of Law Analysis.

- a. e.g., a Maryland business incorporating in Delaware.
 - i. Delaware law favors management.
 - ii. Delaware bench is sophisticated in matters of business.

b. *In Re Renard* 437, N.Y.S.2d 860 (N.Y. Surr. 1981) - Decedent was born a French citizen in 1899. From 1941 to 1971, she was domiciled in New York. She became a U.S. citizen in 1965. In 1971, she returned to live in France, where she died seven years later. While in France she executed a will wherein she left the bulk of her estate in equal shares to a French friend and a French charity. She selected New York law as the law governing her will, for New York law did not provide her son with a forced heirship (as did French law). Upon death, son challenged the proposed distribution of property in New York, claiming that French law should govern and that he was entitled to one-half of his mother's estate. The court upheld decedent's choice of New York law. Accordingly, son did not prevail.

3. Primary Benefits--favorable spendthrift provisions as to the settlor and other beneficiaries with respect to future potential tort liability.

4. Ancillary Benefits:

- a. Domestic and Foreign Trusts.
 - i. Probate avoidance.
 - ii. Confidentiality.
 - iii. Will substitute.
 - iv. Facilitates handling of affairs in the event of disability or unavailability.

- b. Foreign Trusts.
 - i. Global investment opportunities.
 - ii. Ease in transferring assets.
 - iii. Avoidance of monetary exchange controls.

5. Factors to Consider in Selecting Applicable Law.

- a. Favorable Trust Law.
 - i. Nonrecognition of foreign judgments, i.e. no comity.
 - ii. Courts will only apply domestic law to issues arising with respect to trusts domiciled in the subject jurisdiction.
 - iii. Clear legal definitions of what powers and benefits may be retained by settlor without leading to inclusion of trust corpus in settlor's estate for purposes of creditor attachment, garnishment, seizure or other legal process.
 - iv. Clearly defined fraudulent conveyance law.
 - (a) Short statutes of limitations;
 - (b) High burdens of proof.
 - v. Clearly defined/short statutes of limitations.
 - vi. No contingency fees.
- b. Favorable and stable economic, political and social environment.
- c. Favorable/non-burdensome tax laws.
- d. No/minimal language barriers.
- e. Availability of professional services.
- f. Modern telecommunications facilities.

6. Tax Issues.

- a. Properly structured, the foreign situs trust will be tax-neutral, i.e., it will create no significant gift or estate tax consequences to the grantor.
- b. Properly structured, the foreign situs trust will be a grantor-type trust (IRC Sections 671-679).
- c. Gifts in trust will have gift tax implications, but relief may be afforded by:
 - i. Annual exclusion (so long as a "present interest").
 - ii. Unified credit.

iii. Incomplete gifts. Powers that render the trust a grantor trust for income tax purposes will frequently lead to the treatment of transfers to the trust by the grantor as incomplete for federal gift tax purposes.

d. If the trust conducts or merely has the power to conduct a business, it may be taxed as an association (taxable as a corporation).

e. Careful design of the trust can result in the trust being a foreign situs trust for purposes of its administration, interpretation, validity and control, yet a domestic trust for tax purposes.

i. The characterization of a trust as domestic or foreign for tax purposes turns upon:

- (a) The law of the trust's creation;
- (b) The situs of the trust's assets;
- (c) The nationality and residence of the trustee;
- (d) The nationality and residence of the beneficiaries;
- (e) The nationality and residence of the settlor; and
- (f) The situs of trust administration.

f. Reporting Requirements--relevant forms include:

i. Department of the Treasury Form TD F 90-22.1-- Report of Foreign Bank and Financial Accounts.

ii. Form 56--Notice Concerning Fiduciary Relationship.

iii. Form 709--United States Gift (and Generation Skipping Transfer) Tax Return.

iv. Form 926--Return by a Transferor of Property to a Foreign Corporation. Foreign Estate or Trust, or Foreign Partnership.

v. Form 3520--Creation of or Transfers to Certain Foreign Trusts.

vi. Form 3520-A--Annual Return of Foreign Trust with U.S. Beneficiaries.

vii. Customs Form 4790--Report of International Transportation of Currency or Monetary Instruments.

viii. Form 1040, Schedule B also has relevance:

“At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country?”

“Were you the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Form 3520, 3520-A, or 926.”

IX. SUGGESTIONS FOR SPECIFIC ASSETS.

A. Residences.

1. GRIT or GRAT. This is usually the quickest and least expensive step to take. It is also the one with the most obvious estate planning motivation behind it.

B. Raw Land, Jewelry and Art. A GRIT is also excellent for raw land, jewelry and art.

C. Investment Assets. Investment assets, including savings, CDs, muni bonds, money market accounts, limited partnerships, stocks and real estate are good candidates to transfer to an FLP or FLLC.