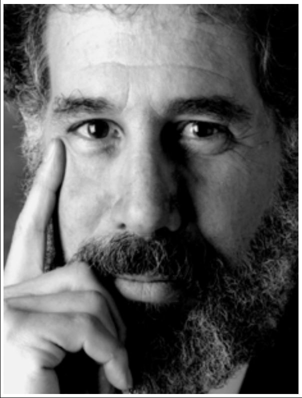

Leimberg's Think About It

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WHAT EVERY FINANCIAL PROFESSIONAL NEEDS TO KNOW ABOUT ASSET PROTECTION TRUSTS

Introduction

When working with closely held business owners and affluent clients, financial professionals focus on strategies that

- Enhance the accumulation of wealth,
- Maximize the benefits of wealth for family and other important beneficiaries, and
- Preserve key assets and overall wealth from unnecessary liability exposures.

Tax management is one aspect of wealth preservation. Portfolio diversification is another. Clients also buy liability insurance and create multiple business entities to manage other potential exposures.

One special tool for managing liability exposures is an *asset protection trust (APT).* An APT is created by an individual grantor to prevent the assets contributed to it from being reached by the grantor's creditors.

APTs are

- Irrevocable,
- For the discretionary benefit of the grantor, and
- For the ultimate benefit of the grantor’s family.

For the purpose of this article, we will assume that APTs are created and administered in the United States. This kind of trust is sometimes referred to as a *domestic asset protection trust*.

Traditionally, an individual could not create an APT that protected the trust assets from the claims of the grantor’s creditors. However, beginning in the 1990’s, some states began creating special rules allowing APTs to shelter assets from the grantor’s liabilities.

For those seeking to advise the affluent, it’s important to be able to understand how APTs work as well as to identify and evaluate the alternatives available to those for whom asset protection planning is important.

Asset Protection Basics

When we speak of asset protection planning, we are referring to the legal techniques that a client may employ to protect personal or business assets against the claims of creditors. In making asset protection decisions, clients should plan based on the types of liabilities they are most worried about.

1. **Unknown Future Creditors—**In general, asset protection strategies are most effective against future creditors who are unknown to the client at the time of planning.

2. **Current Creditors—**Asset protection strategies do *not* usually work against creditors who *already* have a judgment or other undisputed claim against the client. Courts have considered techniques to transfer assets away from the reach of known creditors *fraudulent transfers* and have allowed creditors to reach those assets.

3. **Potential Ex-Spouses—**Situations where one spouse wants to keeps assets safe from the claims of the other in a divorce proceeding typically require different planning tools from those involving unrelated creditors. For example, prenuptial and postnuptial agreements are often used for spouse situations.

4. **IRS and Other Taxing Authorities—**Asset protection strategies that can protect a person from the claims of future creditors provide limited or no protection against the claims of the IRS or other taxing authorities. In fact, Congress has criminalized attempts by taxpayers to avoid paying the IRS. See Internal Revenue Code Section 7201.

5. **Medicaid and Other Government Authorities—**To qualify for certain government benefits, such as SSI or Medicaid, the taxpayer must have assets worth only a limited

amount. Making plans in advance to meet the financial standards is known as *planned impoverishment*. For example, an asset that is protected from the claims of creditors may still be a *countable asset* for Medicaid qualification purposes. In addition, an asset such as the home may be exempt from creditors *and* non-countable for Medicaid qualification, but it may be subject to lien and forced sale after death.

Those seeking to maximize their chances to qualify for need-based government benefits and minimize the potential for asset loss after death usually must employ planning techniques customized to the rules governing the benefits.

Asset Protection Trusts

APTs in the United States are relatively new. In 1997, Alaska was the first state to pass an asset protection statute, which allowed a grantor to transfer assets to a trust company located in Alaska and protect the assets from the Grantor's creditors. Delaware, Nevada, Rhode Island, Utah, Missouri, Tennessee and Wyoming subsequently passed statutes providing for varying degrees of asset protection for grantors of self-settled trusts.

For details about how those states that allow APTs differ in their rules, see Steve Leimberg's *Asset Protection Planning Newsletter* # 109 (July 19, 2007), available at http://www.leimbergservices.com [1]

Types of APT Designs

APTs, like more traditional living or testamentary trusts, may be designed in several different ways.

1. In a *mandatory trust*, some portion of income or principal *must* be paid to the grantor.

2. A *support trust* requires that the income or principal to be distributed to the grantor – but *only* under circumstances defined by an ascertainable standard—usually for health, education, maintenance or support (HEMS).

3. A *discretionary trust* gives the Trustee a very broad ability to decide when and how to make distributions.

To the extent the APT *requires* the payment of income or principal to the grantor, once distributions to the grantor are made, then usually the creditor can attach them. Accordingly, using a discretionary trust and giving the Trustee broad discretion as to whether or not income or principal should be paid to the grantor adds to the trust's protection against the grantor's creditors.

What Other Asset Protection Strategies Are Available?

Creating and funding an APT is not the only way to try to protect assets from the claims of creditors. There are plenty of other techniques available. Here is a short survey of some of the more popular ones.

Give Assets Away

Many who are interested in protecting assets from the claims of creditors simply give their assets to family members. For example, a wife who is a practicing physician may decide to give her assets to her non-physician husband. If someone sues the doctor-spouse for malpractice, the assets owned by the husband should be protected from the claims of the creditor.

What are the drawbacks of this technique?

The biggest downside of giving away assets to maximize asset protection is the loss of control. If an asset is transferred to another person, that person has legal and beneficial control of the asset. In our example, if the husband and wife have a close, trusting relationship, the loss of control would probably not be a big issue.

However, if the spouses have marital difficulties, the husband's sole ownership of most or all of the couple's assets means the wife is in a weaker financial position that she would be but for the planning.

Another potential problem with spousal transfers to avoid liability is that for many types of liability, *both* spouses are at risk. Say, for example, that husband and wife are both active in a family business. If there's a business liability, both spouses MAY be liable for it—depending on business entity and the type of liability. In that instance, having the husband own the couple's assets won't protect them from creditors.

Finally, gifts of assets might get hit with gift taxes. Gifts between spouses would usually qualify for the unlimited gift tax marital deduction, and would *not* be subject to gift taxes. However, substantial gifts to *other* family members such as children — including gifts in trust—would be subject to gift taxes.

Business Entity Formation

Most savvy clients who run businesses have considered whether to put a corporate or limited liability company (LLC) wrapper around their business activities. If done properly, a corporation or LLC can protect the business owners' *personal* assets from claims against creditors of the *business*.

Note, however, that entity formation is *not* a complete answer to protecting personal assets from business liabilities.

Say a physician puts together a professional corporation for his practice. If a patient claims the doctor injured her in the course of providing professional treatment, the patient has the option of suing the doctor *or* the business. The mere existence of a business entity doesn't relieve the doctor from personal liability for his professional conduct.

Closely held business owners also understand that borrowing often means the business owner must guarantee a business loan *personally*. If the business becomes unable to pay its debts, the lender can reach the guaranteeing owner's personal assets.

Transfer Assets Into an Exempt Category

The law protects certain classes of assets from being reached by the owner's creditors.

1. Homestead

Each state has its own rules about the extent to which the primary residence is protected from the claims of creditors. The most generous exemptions are provided by the states of Arkansas, Iowa, Florida, Oklahoma, South Dakota and Texas. Each of these jurisdictions has an unlimited exemption for the value of the homestead so long as the home and surrounding property meet the statutory requirements.

The homestead exemption is not perfect. For example, if the client purchased the home less than three years from the date of a bankruptcy filing, the exemption may be reduced to just $125,000.

The homestead exemption applies only to primary residences, not vacation homes or commercial properties.

2. Pensions and IRAs

The federal government has decided that pension plan assets are exempt from the claims of the participant's creditors. ERISA prevents pension plan assets from being assigned or alienated. See 29 USC section 1056(d)(1). The courts have interpreted this *anti-alienation* provision as protecting pension plans subject to ERISA from the reach of creditors.

The Bankruptcy Act of 2005 extends creditor protection to non-ERISA pensions and to IRAs. The Bankruptcy Act limits the exemption for traditional and Roth IRAs to $1,000,000. The $1 million IRA limitation does not apply to rollovers (including subsequent earnings) from qualified plans and 403(b) plans. The exemption is also unlimited for SIMPLE IRAs or SEP IRAs because they are protected by ERISA's anti-alienation rules.

Some states have statutes exempting the entire value of all IRAs from the claims of creditors.

3. Life Insurance and Annuities

Each state has its own rules about the extent to which life insurance or annuity cash values can be reached by creditors. Some states—such as Florida and Arizona—categorize life insurance and annuity cash values as completely exempt from the claims of creditors. Others—such as Arkansas and New Hampshire—provide no creditor protection for life insurance or annuities. Most states fall between the two extremes.

There is an excellent state-by-state exemption chart available on the web at

http://www.assetprotectionbook.com/s1_asset_protection_state_resources.htm

The chart and other helpful information about asset protection planning are produced by Adkisson Publishing Inc.[1]

4. Offshore Trusts

The theory behind offshore planning as an asset protection strategy is straightforward. A client's assets are transferred to a foreign jurisdiction beyond the reach of U.S. courts. The client structures trusts, corporations or other entities recognized as legal by the foreign government. The asset protection entity created is administered by a foreign person or company not subject to control by the U.S. courts. The combination of foreign entity and foreign control arguably keep the client from being able to repatriate the assets by himself.

If the client is successfully sued in the U.S., the offshore assets are unavailable to the client personally and are outside of the U.S.-based court's jurisdiction. The creditor must go to the offshore jurisdiction and attempt to collect there. Because the foreign country has been chosen for its client-friendly liability rules, the creditor may face spending many thousands of dollars to attempt to enforce the judgment and may still ultimately be unsuccessful in its collection efforts.

So why is offshore trust planning for asset protection out of favor?

The answer is that several U.S. courts have decided that there are limitations, although some highly reputable authorities believe they will work with "good facts." Certainly, they will not work in clear cases of abuse and egregious situations. For example in 2002, the 11th Federal Circuit confirmed that a bankruptcy judge had the right to jail, for contempt, a person who refused to make his offshore assets available for creditors. In that case, the debtor spent *six years* incarcerated for contempt.

In addition to its uncertain effectiveness, offshore planning is generally complex and expensive. Domestic asset protection trust planning was developed as a safer, more accessible and reliable alternative to offshore planning.

Fraudulent Transfer Rules

Every state has rules that provide that if a person makes transfers of assets to cheat a *known* creditor, that person has made a fraudulent transfer. If a court determines that a person has made a fraudulent transfer, that court has the power to reverse the transfer and make the asset reachable by the transferor's creditor.

Fraudulent transfer rules have the potential to apply to *every* kind of technique used to structure assets so that they are beyond the reach of creditors.

What kinds of transfers are fraudulent? It's a great question. Each state has its own rules. Most states have implemented a version of the Uniform Fraudulent Transfers Act (UFTA).

While the particular version of the UFTA implemented in a state may vary, there are three common threads as to what constitutes a fraudulent transfer:

1. The transfer is a gift (or is made for less than full consideration).
2. The transferor keeps direct or indirect control of the assets.
3. The transfer results in the creditor's inability to collect against the transferor.

The fraudulent transfer rules help make asset protection planning an uncertain proposition for those who are worried about particular creditors. For this reason, it is always wise to refer those who are interested in protecting against the claims of creditors to legal counsel that is expert in this field.

Tax Considerations for APTs

An APT is an irrevocable trust, usually funded with the grantor's assets. In most cases, there is no gift tax consequence of making the transfer. The grantor keeps a lifetime interest in the trust, so there is no completed gift.

Most APTs are treated as grantor trusts for income tax purposes, so any trust income is taxed to the grantor as though he/she owned the income produced by trust assets.

Likewise, since the grantor is keeping a lifetime interest in the trust, the corpus will usually be included in his taxable estate.

Legal Requirements to Set Up an APT

The states usually require the following provisions for an APT:

- The trust is not revocable.
- The trust is subject to the law of the state with the statute authorizing the APT.

- At least one of the trustees is a resident of the state authorizing the APT.
- The trust agreement includes state-mandated spendthrift provisions, limiting the right of the grantor (and other beneficiaries) to access the principal.

Advantages of an APT

What are the advantages to clients in creating an APT?

1. **The rules in the states that allow a grantor to create an APT expressly permit an APT's use as a self-settled spendthrift trust.** In the past, clients had to go offshore for self-settled spendthrift trusts. Some U.S. courts have been hostile to the asset protection characteristics of offshore trusts. Domestic trusts expressly allowed by state law seem less vulnerable to attack in U.S. courts.
2. **By statute, a creditor's time to challenge a transfer into an APT under the fraudulent transfer theory is shorter than it would otherwise be.** Most states that authorize APTs limit the time for most creditors to challenge transfers into the trust to four years.
3. **It may be more difficult for a creditor to prove that a transfer to the trust was a fraudulent transfer.** Some APT states require a very high burden of proof on the part of the creditor to successfully claim a transfer was fraudulent.
4. **Implementation should generally be cheaper and easier than offshore trust alternatives.**

Disadvantages of an APT

What are the major disadvantages to clients in creating an APT?

1. **The effectiveness of APTs has not yet been fully tested by the courts.** Since APTs are relatively new, there are relatively few cases testing whether they work. One of the biggest issues is whether a court in a jurisdiction that does not permit the use of APTs will honor an APT created and administered in another state.
2. **The federal bankruptcy code requires APT assets to be reachable for as long as ten years in bankruptcy cases.** While state rules may protect asset transfers to an APT after four years, the exposure may be extended to ten years if the grantor declares bankruptcy.
3. **Unlike foreign trusts, the trustees of U.S.-based APTs are subject to the jurisdiction of U.S. courts.** With offshore trusts, the trustee was also usually offshore and not under the control of U.S. courts. That fact made access to the trust's assets problematic (expensive and troublesome) for creditors and courts. U.S. trusts with domestic trustees don't have the same natural protections.

Case Study

Dr. James Bristol, 49, is a divorced surgeon with a $40 million net worth. James has three children, and he is concerned about his potential exposure to future malpractice or other liability claims that may not be covered by insurance. James is currently involved in a lawsuit under which a former client is suing him for $100 million. The case is scheduled for trial in March of 2010.

James is a resident of Tennessee, and he has three children between the ages of 19 and 25. James is a part owner of a surgery center and the sole owner of his own professional corporation.

James decides to visit with his attorney, CPA, insurance professional and financial professional for advice about protecting his assets. They recommend he consider the following strategies:

- **Maximize the amounts James contributes to IRAs and pensions.** Not only are such contributions tax-advantaged, the natural asset protection characteristics of those assets help further James's asset protection goals.
- **Consider increasing the funding for existing life insurance and annuity products.** In Tennessee, life insurance and annuities intended to help family members gets statutory protection against the claims of the policy owner's creditors.
- **Consider the purchase of additional needed life insurance coverage or deferred annuities.**
- **Evaluate whether the current business entity structures are efficient from tax, administrative and liability management perspectives.** James already has two business entities in place. Might it make sense to create another? If assets are transferred into one of the entities, is James's liability protection stronger? If assets are transferred out of an entity and into a personally owned exempt asset, are asset protection goals furthered?
- **Evaluate James's current liability insurance coverage and limits to make sure they are appropriate and adequate.**
- **Consider the implementation of an APT funded with assets that James does not consider essential to his current needs.** If James decides to create an APT, it ought to provide for discretionary distributions to him during his lifetime, with the remainder at his death to go to his kids. Since the APT is irrevocable, it makes sense to put only non-essential assets into it, as James will be giving up direct control of those assets for the rest of his life.

James's current known creditor might be able to reverse some or all of the proposed asset transfers if a judgment is obtained and enforcement is pursued. Future creditors would have a harder time getting at assets in the exempt categories or in the APT.

If James's potential future creditors have to work hard and at great expense to collect their judgments, they are likely to be motivated to settle at reduced amounts—saving wealth for James and his children.

Conclusion

With news headlines announcing multi-million dollar jury awards in lawsuits, it's easy to understand why clients might implement asset protection strategies.

Asset protection trusts are a key tool to consider as part of an overall asset protection plan. While such trusts have been available for a relatively short time, they have advantages over older techniques, such as offshore trust planning.

Asset protection trusts are not a complete asset protection answer, nor are they right for every client. Since the rules surrounding asset protection are state-specific and fact-specific, it is wise to involve a client's professional advisors – particularly an expert in the asset protection field – early on in the process. The skills of the client's attorney, CPA, insurance professional and financial professional may all be required.

Financial and life insurance professionals can offer alternative tools to APTs, such as life insurance, annuities, retirement plans and IRAs, that can generate protection against the claims of future creditors.

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[1] *Prudential does not endorse and is not affiliated with these websites or publishing companies. These examples are provided solely for training purposes as examples of available resources on creditor protection.*

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