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The Asset Protection Planning Continuum – Practical Steps for Estate Planning Lawyers and Other Professionals

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Asset Protection Planning for Every Client

For clients, better asset protection is almost always an advisable goal. Asset protection is simply planning to minimize the risks to clients' assets and financial health that a range of risks might pose. These risks might include the costs of a lawsuit, malpractice claims for clients who are professionals, the financial impact of divorce, and suits relating to a client serving on a charitable board. Asset protection is not limited to costly trusts set up in foreign jurisdictions with uncommon sounding names. While that might be part of the asset protection tool-kit it is not the focus of asset protection for most clients. Nor is asset protection reserved for wealthy entrepreneurs and surgeons. Every client, and every practitioner, has engaged in some degree of asset protection planning. However, by thinking about the asset protection process, and being more deliberate in guiding clients to address creditor and divorce protection risks, among others, all practitioners can enhance the services they provide.

The Asset Protection Continuum

Viewing asset protection as a planning continuum will help advisers who have not specialized in this area become more comfortable making it a part of their regular planning repertoire. It will also help clients who may not view themselves as needing significant or costly protections better understand how and why they should undertake asset protection steps.

How far each client will move on that continuum will depend on the client's perception of risk exposure, the costs and complexity of the steps, and the client's perception of the costs/benefit trade off of each additional step up the planning continuum. For estate planners in every discipline (CPAs, attorneys, wealth advisers, insurance consultants, etc.) understanding the asset planning continuum, and how to use it to build awareness and advise every client as to appropriate asset protection planning steps, should have always been a vital part of the estate and financial planning process. With the evolving nature of estate planning this will become a more important part of the process.

- For many clients, relatively simple and low cost steps might suffice to enhance their asset protection. Buying a homeowners and auto insurance policy is asset protection. Determining the size of the deductible and the maximum level of coverage (e.g., whether an excess liability policy is purchased) is asset protection planning at the simplest level.
- Moving forward up the asset protection continuum might involve creating a life insurance trust to protect the cash value of the life insurance (assuming it is not protected under state law) or setting up a limited liability company ("LLC") to own a rental property or home based.
- Perhaps on the higher end of the asset protection continuum might be the creation of an asset protection trust funded with a tier of entities.

Often, simpler and less expensive techniques can be used instead of, or in conjunction with, creditor protection trusts like DAPT and FAPT planning, and not all of these techniques are well understood or typically used by advisors and their clients. Focusing more attention on these alternative asset protection planning techniques will enable practitioners to offer a wider variety of more cost effective asset protection techniques to a wider array of clients. This will benefit clients and help practitioners expand their practices by creating a new driver.

The asset protection continuum is obviously a simplifying paradigm and cannot rigidly be applied. In some client situations lower level steps on the planning continuum will not suffice and, a jump to higher levels may be required. It is also important to recognize that the simplifying nature of the planning continuum can obscure important differences. A spousal lifetime access trust ("SLAT") in which one spouse creates a trust for the benefit of the other, can vary significantly in how protective it is depending on a number of factors such as: what state it is formed in, what distribution provisions are provided for, whether an independent institutional trustee is named or the beneficiary spouse, and so on. Nonetheless, the continuum will provide a useful analogy to guide many clients to pursue more asset protection planning. It will hopefully provide practitioners who do not specialize a useful model to gain more comfort with asset protection planning. As practitioners proceed up the planning continuum if they reach a level of planning that is appropriate for a particular client, but beyond their skill set they can partner with other advisers to provide that level of planning.

Taxes Will Not be the Driver They Had Been

Whatever happens with respect to the tax system, the litigious nature of society is unlikely to be impacted. In recent years the federal estate tax exemption has risen to nearly $11 million for a couple (2017). Only about 18 states have death taxes, and the trend appears to be toward higher exemptions or repeal. The Trump administration might succeed in fulfilling a long-time Republican goal of eliminating the federal estate tax. While many estate planners have focused more on maximizing income tax basis and other income tax planning issues, the reality is that this will not suffice to replace the driver for business that the estate tax had been. If the estate tax is in fact repealed the psychological consequence to many clients, in terms of eliminating the fear of the death tax, may take a more significant toll on business than the increasing exemptions have taken. For many practitioners, other drivers will have to be developed. One such driver to consider emphasizing is asset protection planning.

There is another important point to asset protection planning. Estate tax planning has often provided a strong non-asset protection justification for steps that may also have asset protection benefits. If the estate tax is repealed this rationalization for planning will also disappear. For those clients that would otherwise defer all planning waiting to see what happens this could be an important factor.

Insurance Coverage

Perhaps the first step on the asset protection continuum is a review of the client's property, casualty and liability coverage. This is something all clients should undertake.

Consistent with one of the themes of this article, asset protection planning can entail a large spectrum of planning steps ranging from simple and inexpensive to very complex and costly. In many situations practitioners should confirm that the lower end of the spectrum has not been overlooked before or in lieu of jumping to more advanced planning techniques. Many clients have rental properties, land investments or residences used by other family members that have no or inadequate coverage. One of the first steps for all clients should be making certain that the client has adequate underlying and umbrella or personal excess liability insurance in place for a given asset or activity that could cause liability. Few practitioners will have the expertise to determine specific coverage levels, but most practitioners will have the ability to spot some issues and direct clients to retain insurance consultants to review details. It is surprising how many clients, even those with significant wealth, have inadequate or no personal excess liability coverage.

Some common insurance planning oversights include the following:

- No or inadequate personal excess liability (umbrella) policy. Many clients have never had their liability coverage reviewed. A surprising number of clients simply are lacking this type of coverage, which could expose most or all of their assets to claims. In some instances, e.g., when the client has different insurance companies providing underlying homeowners and the umbrella policy, there are gaps between underlying coverage and the umbrella.
- Insurance for a rental or family use property is sometimes inappropriately underwritten as a primary residence coverage. Example: Mom and dad own a condominium in the city which daughter lives in. When they purchased the condominium it was erroneously insured as their residence. It may be more appropriate to have the parents own a landlord policy and their daughter to maintain a renter's policy to assure proper coverage.
- Old coverage. It is not uncommon to find that clients have old property, casualty or liability coverage that was simply never updated. They may have had a home business and when they closed it the rider for it was never cancelled, or more dangerously, they started a home based business and never discussed with their insurance agent what coverage might be necessary to insure the additional risks that provides. Values of coverage may be very out of date. When is the last time the client had collectibles appraised to assure that there is sufficient coverage?

For every client, confirming that they have had a recent review of all property, casualty and liability coverage should be a base step of asset protection planning.

Nature and Title to Assets

The nature and ownership (title) to assets can have important asset protection ramifications.

It is often wise to keep assets in the name of the spouse who does not have significant liability exposure. This is often referred to as the "poor person's asset protection plan." It often incurs no cost, but the protection provided may prove to be inadequate. The tales of the supposed non-risk spouse being sued for an automobile accident and losing the family wealth are legion. So while this might provide some protection, it should rarely be relied on. Further, if the lower-risk spouse dies and his or her will does not assure that the assets pass into an appropriately protective trust for the surviving at risk spouse, any protection may be lost. In most states, assets acquired from earnings and growth in value during the marriage will be shared equally upon divorce, even when those assets have been kept in the name of one spouse or the other. Otherwise, a prenuptial or postnuptial agreement can be entered into to assure that marital assets will be divided equally in the event of a divorce, and left for the benefit of the surviving spouse in the event of death.

Example: Where one spouse is a neurosurgeon and the other is a school teacher, it superficially has appeal to put the bulk of otherwise unprotected assets under the school teacher's name, or under a revocable trust that will not protect from creditors but will protect the assets from guardianship and probate if the school teacher dies or becomes incapacitated. But as noted above if the school teacher dies without appropriate trust planning the assets will pass back to the neurosurgeon unprotected. If the simplistic approach is used the school teacher spouse's will or revocable trust should include appropriately protective trusts to be funded on his or her death to protect the surviving neurosurgeon spouse. Liability insurance should be reviewed to assure that the school teacher is sufficient protected in the event of possible claims. But in all events, this should be viewed as the minimum of a plan and perhaps at most a temporary first step on the planning spectrum.

It is noteworthy that community property may be accessible to the creditors of one spouse, and that special procedures must be followed in order to terminate the status of community property under the transmutation rules in some states.

Tenancy by the entireties property ownership, depending on state law, may provide a meaningful measure of protection. While relatively few states provide that the creditor of one spouse cannot reach tenancy by the entireties property, which is a special form of ownership that only exists between married couples, the bankruptcy law will normally recognize tenancy by the entireties with respect to jointly owned real estate that is located in a tenancy by the entireties state, such as Michigan, Florida and Delaware. Caution should be exercised as a "last minute" transfer into tenancy by the entireties where a creditor already exists could be set aside pursuant to the fraudulent transfer rules that apply in the jurisdiction where the debtor lives, and also that joint debt other than a mortgage on the homestead may cause loss of tenancy by the entireties protection if one spouse files bankruptcy.

What about foreign accounts and entities? It is difficult and sometimes almost impossible for a creditor to reach foreign assets because many jurisdictions do not recognize U.S. judgments, and would require a completely new jury trial in the jurisdiction itself before a judgment would be given that would enable a creditor to attach an account in that jurisdiction. The same can apply with respect to stock owned in a foreign company where the stock certificate is also held in that foreign jurisdiction. Any type of foreign planning, however, can be fraught with a significant number of traps for the unwary, which could include having a judge put a debtor into jail on contempt of court charges if the judge has the authority to order the debtor to bring the assets back to the jurisdiction where the court is sitting, or the debtor has transferred the assets at the last minute in a "fraudulent transfer." Nevertheless, many debtors have used foreign asset situations to convince creditors to settle upon favorable terms.

Roth Conversion

Converting an IRA to a Roth IRA and paying the income tax triggered from unprotected assets may be a useful and easy to implement asset protection strategy. If state law protects both the IRA and the post-conversion Roth IRA the conversion will use up liquid assets held outside the protection of the IRAs, e.g., funds in a brokerage account, to pay the income tax triggered on the conversion. The result will be full post tax dollars protected by the Roth IRA rather than merely pre-tax dollars protected in the regular IRA. Also, Roth IRAs have no mandatory distribution rules for the plan holder so dollars will not have to be removed from that protective structure as they eventually will from a regular IRA.

State Exemptions

Most planners are aware that each state has certain creditor "exemptions" that will provide protection for "exempt assets" that are purchased before a creditor problem arises, or with the proceeds from other exempt assets. Every advisor should be familiar with the exemption laws of his or her state if those are material. Some states, like Florida, have exemption rules that are extremely favorable to debtors, and can include protection of an unlimited or high homestead value, the cash value of life insurance policies, annuity contracts, IRAs, pension accounts, tenancy by the entireties assets owned by a married couple, 529 College Savings Plan accounts, Health Savings Account, and other categories of assets.

Example: Move to Florida and buy a big home. Florida is one of the few states to have an unlimited homestead exemption, and the Florida Constitution's homestead protection trumps its fraudulent transfer law, meaning that a debtor with a judgment against him could move to Florida and buy a big house and not be pushed out of the house even if this was an intentional "fraudulent transfer" of previously owned non-exempt assets. It is noteworthy that the 2005 Bankruptcy Act provides that home equity that is attributable to a fraudulent transfer made within ten years before the filing of a bankruptcy can be lost if the debtor ends up in bankruptcy, but it normally takes three creditors to require a debtor to be in bankruptcy if the debtor has at least twelve legitimate creditors.

Other states, like Nevada, have very limited creditor protection exemptions, and in some situations the only exemptions that can be relied upon are those provided under Section 522 of the Bankruptcy Code, which are somewhat limited but include certain real and personal property, retirement funds and homestead.

If the client's state has meaningful exemptions this might be a relatively simple and inexpensive planning step to retitle or purchase additional protected assets to provide incremental protection.

Simpler Irrevocable Trusts

The use of irrevocable trusts is the foundation for many asset protection plans. Protective trusts should be used at each phase of planning. A typical irrevocable life insurance trust ("ILIT") or trust for children or other heirs, can provide asset protection benefits. Consider:

- Parents should bequeath assets into long term trust for heirs rather than make outright bequests. If benefactors for the client make all gift or testamentary transfers into protective long term trusts for the client the client may be able to have access too, and meaningful control over, those assets, without exposing them to his or her creditors, divorce or other predators. Some commentators refer to these protective yet flexible trusts as beneficiary controlled trusts.
- Spouses and partners should gift and bequeath assets to each other only in protective long-term trusts. Caution should be exercised when spouses (and even other family members) plan to address the reciprocal trust doctrine. While this is a tax doctrine that may enable the IRS to unravel planning, it may also permit a creditor to challenge contributions made by one spouse as having been made by the other spouse when both spouses are funding similar trusts for one another within a relatively short period of time. Many practical steps can be taken to weaken this type of challenge by forming the trusts in different jurisdictions, naming different beneficiaries, using different trustees, varying the terms, not signing the trusts at the same time, funding the trusts with different assets, and so forth.
- Single individuals may have few options other than funding a trust that they themselves are a beneficiary. See discussion of self-settled domestic asset protection trusts ("DAPTs") below.

Too often clients bequeath assets outright, or even if they use trusts, they do so in a matter that is not optimal. With the increases in estate tax exemption, and even more so if the Trump administration repeals the estate tax, there will be less likelihood that clients who should use trusts for asset protection will do so if the tax incentive is irrelevant. This is why practitioners must proactively educate clients about the importance of trust planning regardless of what happens with future tax changes.

Many irrevocable trusts are simply structured in a manner that is not optimal from an asset protection perspective. Consider the following common shortcomings:

- One of the common issues with trusts is that the distribution provisions are structured in a manner that characterizes them as "support trusts." This gives the trustee the power to pay trust income to provide for the health education maintenance and support ("HEMS") of the beneficiary. A support trust is somewhat protective of beneficiary's interests because the beneficiary is only entitled to distributions for his or her support. A spendthrift provision should be included. But, in some states, a support trust is not as protective as may be necessary to protect the beneficiary because the distributions to maintain support may be reached, and depending on state law put the trust at risk in the event of the beneficiary's divorce. A preferable approach is to structure trust distribution provisions as a discretionary trust. In contrast to a support trust, distributions under a wholly discretionary trust are made only in the discretion of trustee. The creditors of a beneficiary of a discretionary trust should not be able to compel the trustee to pay. This is because the interest of the beneficiary does not qualify as a property right so even preferred creditors like spouses may be prevented access. However, it may not provide protection in some jurisdictions from what might be characterized as "super creditors", which include the Internal Revenue Service, the Federal Trade Commission, and the FDIC.

- Ideally, an independent trustee other than the beneficiary should be named.
- Traditional trusts often distributed assets at specified ages and ended at some specified age, e.g. one-third at age 25, one-half of what remains at 30 and the balance at 35. These mandated distributions and terminations undermine the protection of these trusts from an asset protection perspective.

If a trust is identified that is less than optimal from an asset protection perspective, there may be options to modify the trust to enhance the asset protection benefits of the trust:

- Modify the trust by actions of a trustee or trust protector if permitted under the governing instrument.
- Decanting the trust into a new trust that has better administrative and distribution provisions.
- Merge the existing trust into a new trust that has better administrative and distribution provisions.
- Effect a non-judicial modification pursuant to state statute if the settlor is alive and all beneficiaries are of age or can be represented virtually.
- Move the trust to an asset protection trust jurisdiction by changing trustees, if this will provide protection by the laws of such jurisdiction.

The following discussion summarizes a few of the many different types of irrevocable trusts that may be used in asset protection planning. Many practitioners might view these as more complex and further up the asset protection continuum then a more traditional irrevocable life insurance trust ("ILIT"), or a children or grandchildren's trust.

Qualified Personal Residence Trust ("QPRT")

A Qualified Personal Residence Trust ("QPRT") is a technique whereby a taxpayer gifts his or her home to a special trust while reserving the right to live in the home rent-free for a fixed number of years (the "QPRT term"). Upon the expiration of the QPRT term, the children (or a trust for their benefit, often a grantor trust) will own the home. The parent may continue to live in the residence after the QPRT term pursuant to a fair market lease arrangement.

The estate tax planning advantage of a QPRT, assuming a taxable estate, is that the technique can be used to leverage the gift of a taxpayer's personal residence out of his or her taxable estate. The leverage is in part due to the fact that the parent/donor retains the right to live in the house rent-free for a fixed number of years. That retained right delays the beneficiary's receipt of the residence and reduces the value of the gift of the home on a present value basis. Often QPRTs represented an acceptable form of gift because clients could retain their liquid assets intact to cover living expenses. For most moderate wealth clients, there may be no tax benefit from

QPRTS with a $5 million inflation adjusted exemption. Why give up the possibility of the basis step-up at death if the client's estate won't be taxable? A QPRT, however, might provide some measure of asset protection planning benefits since it transforms an outright equity interest in the home into a mere term of years' interest that should not be particularly valuable to a creditor. Consider the following:

- If the client is married and lives in a state that provides for tenants by the entirety protection for a home, e.g. New Jersey, practitioners must weigh the possible benefits and limitations of that protection versus the benefits, restrictions and income tax consequences of a QPRT.
- If the state provides a valuable homestead exemption, e.g., Florida, using a QPRT might reduce protection.
- If the client is single a QPRT may be useful, simpler and perhaps safer than transferring the house to a limited liability company which would be held in whole or part by a self-settled DAPT.

A QPRT transaction may be planned and implemented along the following lines:

- Husband and wife jointly own a personal residence. The deed is re-titled to tenants in common so that each spouse owns a one-half interest in the home.
- Counsel creates a separate QPRT trust for each of husband and wife. Being mindful of the reciprocal trust doctrine a different independent trustee is used on each trust and the term of each trust is set for a different number of years. Other differences may also be incorporated in the trusts, although it is unknown how state courts may apply the reciprocal trust doctrine in creditor situations.
- The home is appraised with consideration to possible fractional interest discounts. Under current law if a husband and wife each transfer ½ of a tenant in common interest in a home into a separate QPRT a discount on the valuation of each of those partial interests may be permitted. If the proposed changes in discounts are enacted this further component of leverage for QPRTs will be lost.
- Each of husband and wife gift their one-half interest in the home to their respective QPRT.
- If either spouse outlives the term of their QPRT the 50% interest in the home is transferred to a remainder trust for the children. By using a grantor trust at the "back end", if the parents wish to continue living in the home the rent they pay to the trust would be disregarded for income tax purposes since it would be tantamount to paying themselves rent. If the QPRT remainder trust is a grantor trust an important issue is whether that trust would be grandfathered if the QPRT is executed and funded before a change in the law or whether possible restrictions on grantor trusts will apply such that the remainder trust may not be treated as having received the home until after the negative law change occurs.

The Treasury Regulations provide that a QPRT may provide that the contributor will receive an annual, or more frequent, annuity payment if the house is sold during the retained use term. In some states an annuity payment interest is creditor protected, and careful drafting may be necessary to facilitate exemption qualification.

Spousal Lifetime Access Trusts ("SLATs")

Spousal lifetime access trusts (SLATs) can provide a valuable asset protection benefit for married couples. Non-reciprocal SLATs are a common planning technique.[1] These trusts are more robust versions of more traditional irrevocable life insurance trusts ("ILITs"). In fact, properly structured (e.g., with a separate insurance trustee and appropriate insurance provisions) SLATs can hold life insurance and in many instances may be used in that context to eliminate old ILITs simplifying and improving the client's planning.

With SLATs each spouse creates a trust for the benefit of the other spouse that may include other sprinkle beneficiaries. The couple can effectively move significant assets into trusts yet continue to access all of those assets. The risks of SLATs include premature death which can be insured against, and the possibility of divorce. How might divorce impact a SLAT plan if one of the premises of the plan is that each spouse might indirectly benefit from the assets of the trust they create through the distributions to their spouse. Divorce would undermine that access.

SLATs are almost always structured as grantor trusts so that the income is taxed to the settlor. This will result in the clients paying income tax on income earned in the SLAT thereby reducing their estate and accelerating the growth of assets inside the SLATs. This is also a valuable asset protection benefit as the protections will be enhanced each time the clients/grantors make income tax payments to cover SLAT income. The power of this grantor trust tax burn on the clients' estates can be powerful. Even a moderate gift by a married couple both age 65 to two non-reciprocal spousal lifetime access trusts ("SLATs") can shift over the duration of the couple's life a substantial portion of their wealth outside their taxable and creditor-reachable estate. Monitoring this common planning strategy can permit the couple's advisers to monitor and modify the planning in future years by making distributions to or for the couple's benefit if lower investment returns or higher expenses are realized, or by suggesting additional gifts.

Example: Assume husband and wife age 65 and a net worth of $7 million, $1 million in a house and $200,000 in tangibles. Assume the couple has general lifestyle expenses of $150,000, medical expenses of $15,000, and charitable expenses of $10,000 and property taxes of $25,000. These total $200,000. The "burn rate" is about 2.85% on the entire net worth, about 3.5% on investable net worth (i.e., net worth excluding tangibles and the house), and 4.2% on the investment net worth excluding the SLATs. The asset allocation in the SLATs should more aggressive then for non-SLAT assets since it is a longer term investment "bucket." At a 70% confidence level, which some advisers deem sufficient for these purposes, the non-SLAT investment assets at death would be $1,313,754. While this might suggest a greater allocation to the initial gifts to the SLATs could be justified, retaining greater assets in the client's names unfettered by having to access the SLATs may be a more comfortable plan for the clients. Depending on the client's asset protection concerns forecasting can be used to fine-tune how much can reasonably be transferred to the SLATs without comprising the clients' ability to support themselves, hence defecting a future challenge that the transfers were a fraudulent conveyance. Note that at a 50% confidence level the investment assets outside the SLATs

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[1] 909." Beware of the Reciprocal Trust Doctrine: If not set up properly, a popular strategy could backfire." Martin Shenkman and Bruce Steiner. Trusts & Estates Magazine, April 2012. pp. 14-18

could be $3,273,007. If the periodic updates of the financial forecast confirm a trajectory on this level or better, than additional transfers could be made to the SLATs or outright gifts if the gift model discussed elsewhere suggests that is appropriate. Bear in mind that these figures do not include house or tangibles. The projected level of assets in the two SLATs at a 70% confidence level is $3,220,197 providing a meaningful state estate tax savings if the couple lives in a decoupled state. At a 50% confidence level nearly $5 million or $4,855,092 of assets are removed from the taxable estate and held in the SLATs. Again the forecasting sensitivity analysis can be used to backstop the planning and support the reasonableness of the transfers. What is an appropriate confidence level to deflect a claim that the clients transferred to large a portion of their wealth? The appreciation inside the SLATs and the use of a swap power to pull unrealized appreciation back into the grantor's estate would have to be monitored so that the potential capital gains cost does not outweigh the state estate tax savings. If, however, the estate tax is repealed in favor of a capital gains tax on death this planning would have to be reconsidered. Depending on the structure of such a new law the same swap planning may be appropriate, or perhaps inverse swapping to shift appreciation out of the client's estate and into the trust to avoid a capital gains tax on death may be preferable. But in all instances the transfers to the SLATs may have provided valuable asset protection benefits regardless of the changes to the estate tax system. Importantly, if financial forecasting is integrated into the initial planning phases the client may have a better understanding of how much to transfer and a better result if the transfers are later challenged.

Beneficiary Defective Irrevocable Trust ("BDIT")

Beneficiary Defective Irrevocable Trusts (" BDITs") (also called Beneficiary Defective Trusts or "BDTs"), may provide valuable asset protection benefits. An illustration of a possible BDIT plan/technique follows.

The BDIT is an irrevocable trust that uses the common Crummey power that is nearly ubiquitous in insurance trust planning, to allow someone other than a third party benefactor (such as a client's parent) who establishes the trust for the client and his or her family to be treated as the owner of the trust property for income tax purposes. For instance, the client for whom the BDIT was created can be treated as the owner of the trust for income tax purposes only (i.e. the BDIT is a grantor trust as to the client not the actual settlor). The settlor, e.g., the client's parent, establishes the trust and makes a $5,000 gift to the trust. The client as beneficiary has the right to withdraw that cash gift using the Crummey power, lapsing power of withdrawal, but does not do so. As a result of the client holding a right of withdrawal under a Crummey power, Code Section 678 treats the client as the owner of the trust property for income tax purposes. This tax characterization is vital to the planning applications.

The client never makes any gratuitous transfers to the BDIT. The trust is intentionally designed so that it is not a grantor trust as to the settlor. This will enable the client, as deemed owner of the trust property for income tax purposes, to sell appreciated assets to the BDIT without triggering income tax consequences. Some practitioners believe that because the client is not the settlor of the trust the BDIT is superior to a self-settled DAPT discussed below. This is why the BDIT is illustrated earlier or lower on the asset protection planning continuum than the DAPT or FAPT below. Once the BDIT is established the client transfers appreciating assets to the BDIT via a nontaxable note sale similar to the traditional note sale to a defective grantor trust.

Why go through these additional machinations to differentiate the BDIT from the DAPT which would permit the same type of sale? Proponents of BDITs argue that a drawback to the DAPT is that the client is the person establishing the trust and making transfers to it. Because the client is the one making the transfers to the DAPT, his or her control over the transferred assets must be substantially limited if the desired estate tax benefits are to be achieved. This drawback, BDIT proponents argue, can be improved using the BDIT technique. Because the client will not make any gratuitous transfers to the BDIT, the assets inside the BDIT are, according to many practitioners who use the technique, more secure from claimants than the assets held in a DAPT. The BDIT is an approach that enables the client to be in substantial control of the transferred wealth, have the use and enjoyment of the trust assets, have the ability to alter beneficial interests in the trust through a limited testamentary power of appointment, have divorce and creditor protection, and estate tax savings (which again will depend on future changes in the transfer tax laws). This is supposedly achieved without some of the perceived risks of self-settled trusts or DAPTs. Some commentators, who are not as comfortable with the BDIT technique, may reduce the control provisions granted to the client to make the BDIT, in their view, more secure.

Many planners caution that a court may consider the beneficiary of the BDIT to be a contributor if the beneficiary has sold assets on a discounted or otherwise advantageous basis to the BDIT, or if significant leverage has been used that would not be common under normal commercial transactions.

Entities, Contractual Relationships and Other Steps

The following steps, are some of the most common and can often be harnessed for a large number of clients in a cost effective manner. In addition to creditor protection, there are important steps that can be taken to shield clients from liability, which includes prudent use of limited liability companies (“LLCs”) and other limited liability entities (corporations, S Corporations, limited partnerships, limited liability partnerships, etc.).

In addition to entities it may be feasible to provide some measure of protection by reasonably re-characterizing relationships, such as by making employees into independent contractors and outsourcing risky activities to third parties. Some of the key and easy ways to effectuate creditor protection mechanisms for individuals who have assets that are not protected under the statutory exemptions may include the planed use of entities and legal relationships.

Many clients will benefit from the planned use limited partnerships and limited liability companies (“LLCs”) to help make assets much more difficult to be reached by a judgment creditor.

Example: A judgment holder could levy upon all stocks and bonds owned by a debtor. However, before any claim arose the client transferred assets to an LLC. The client/debtor owns 95% of the LLC and the remaining 5% of the membership interests are owned by her parents, or a trust for her children. In most states the creditor cannot reach into the LLC, but generally will only instead receive a charging order which gives the creditor the right to receive 95% of any distributions, but only if and when there would be a distribution. The courts will normally not have any power to require distributions, so creditors typically negotiate favorable settlements when their only avenue is to receive a charging order.

But even this planning without more may not provide the desired and anticipated protection. The LLC must be operated with appropriate formalities. Ideally it should have a written operating agreement, separate bank account, funds should not be commingled, a valid business purpose for the LLC should exist, proper books and records should be maintained, tax returns filed appropriate and distributions made in accordance with the ownership interests in the LLC. If the client participates in annual meetings with all of her advisers and permits professionals to guide the operational formalities, the likelihood of success may be significantly enhanced.

Business and Entity Protection

A number of common, but not used with sufficient frequency, business arrangements may help to provide protection from having potential future creditor claims decimate a business or professional practice. The following discussion covers only some of these planning opportunities. Quite often there is one business entity, which may be an LLC or regular corporation, which conducts the business, owns furniture, equipment, inventory and accounts receivable, and files taxes as a separate entity, which may be as an S corporation, a partnership, or disregarded for income tax purposes.

The tax treatment of the business entity can play an important role in what can be done from a coordination standpoint. Many advisors are not aware that an LLC may elect to be treated as a regular "C" corporation, an S corporation, or a partnership for federal income tax purposes. The risk of losing the assets of the company to a future creditor can be significantly reduced by using some of the following strategies. However, before implementing further strategies, first assure that the business is being operated with all appropriate formalities. Consider: obtain a certificate of good standing to confirm the status of the business; obtain and review all governing documents to assure that they are adequate, reflect current ownership interests, and are being adhered to; confirm that there is a CPA preparing adequate books and records, monitoring distributions, testing or reviewing compensation and perquisites to be certain that they are reasonable; and so forth. Once the basics are addressed, explore additional step:

- Move assets out into a separate leasing or licensing entity that can have an arm's-length relationship with the operating entity, if this will not trigger material taxes. It may be possible for a business entity taxed as an S corporation or a C corporation to avoid taxes being incurred upon separation by entering into what is known as a new Parent F reorganization, whereby a new company will own the existing operating company and a new "brother/sister company" that can receive valuable assets from the operating company without triggering income taxes.
- Have the company owe shareholders pursuant to loans, or indebtedness to others. A legitimate creditor can be given a lien against entity assets in the same way that a bank normally takes a mortgage lien against a house. Liens given against physical assets and

also intangible assets like accounts receivable are normally "perfected" by the filing of UCC-1 Financing Statements in the state where the assets are maintained. Consider factoring accounts receivable to an entity owned for the primary benefit of family members in the next generation, to help with estate tax planning, and also pare down the balance sheet.

Domestic Asset Protection Trusts ("DAPTs") and Foreign Asset Protection Trusts ("FAPTs")

When most practitioners think of asset protection planning the first thoughts often turn to domestic asset protection trusts ("DAPTs") or foreign asset protection trusts ("FAPTs"). While a high percentage of the literature on asset protection for estate and business planning lawyers and advisors concentrate on asset protection trusts, there are a good number of planning techniques and arrangements which provide excellent creditor protection planning without the need for the complexity and expenses associated with an asset protection trust, whether a DAPT or FAPT.

Risks and Challenges of DAPTs

In the *German*[2] case the question at issue was whether the decedent held interests in the trust that caused estate tax inclusion. In 1969 the decedent transferred property to an irrevocable trust. The trust permitted the trustees, in their absolute discretion, to pay any or all of the income or principal of the trust to the decedent at any time during her lifetime. The precondition to any such distribution was that the trustee had to first obtain the written consent of the beneficiary who was entitled to receive the principal and accumulated income of the trust after the decedent's death, i.e. the remainder beneficiary.

If the decedent, as a result of this arrangement, was to be considered from an estate tax perspective as if she continued to enjoy the right to the income or principal of the trust until death, the trust assets would be included in her estate. This turned on the application of Maryland law. Specifically, the issue was whether under Maryland law, if the decedent incurred any debts during her lifetime, could her creditors still attach trust assets to collect those debts. The court found that Maryland law did not give decedent's creditors the right to reach trust assets, and, accordingly, her gifts were completed at the time she transferred the assets in trust, and they were no longer subject to estate tax on her death.

In 2009 the Internal Revenue Service ("Service") issued a private letter ruling which concluded that a trustee's discretionary right to pay income and principal to the grantor, the grantor's spouse and descendants, did not cause the trust assets to be included in the grantor's estate.[3] But the Service warned that if there was a pre-existing arrangement or understanding between the grantor and trustee that the assets would be included in the grantor's estate. This points to the importance of operating the trust properly and carefully. This suggests that the operation of the trust would be critical to the determination of estate exclusion.

[2] Estate of Estelle E. German v. The United States, 85-1 USTC ¶13,610, U.S. Claims Court, No. 734-81T, 3/26/85.

[3] *See* PLR 200944002 and Rothschild, D. Blattmachr, Gans, J. Blattmachr, *IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate*, 37 Est. Plan (Jan. 2010).

In 2011 an Alaska court, in Mortensen, held that transfers to an Alaska DAPT were included in the grantor's bankruptcy estate, and hence, reachable by his creditors.[4] This was a classic "bad facts" case. The grantor was in dire financial straits when he established the trust, had credit card debt, and was struggling with post-divorce financial issues, when he transferred substantially all of his property to the trust. The facts were as opposite as they could be from those of a wealthy taxpayer planning to fund millions of dollars to a completed gift DAPT in 2012 for estate planning purposes. Mortensen was clearly not an appropriate candidate for a DAPT, the planning was poorly designed and executed, but most significantly, he filed for bankruptcy less than ten years after funding the trust. Under the bankruptcy law, during the 10-year period following transfers to a self-settled trust, the bankruptcy trustee can avoid the transfer. So, the lessons of Mortensen are to be certain that your client is an appropriate candidate for a DAPT, execute the planning with prudence, and if your client runs into trouble don't file bankruptcy if it can be avoided for the 10-year window. In spite of the bad facts this case created negative perceptions of DAPT.

A specific concern Mortensen creates for DAPTs is that, according to some commentators, a transfer to a DAPT is a per se fraudulent transfer, if such a transfer were a per se violation of the fraudulent transfer rules, then creditors could reach the assets in the trust, so that the trust assets would be included in the taxpayer's estate. Not all commentators agree. Others believe a transfer must be consummated with an actual intent to defraud, and that the "per se" concept is too harsh an interpretation. The "per se" theory, they argue, if extended to its natural limits, could conceivably characterize every gift any taxpayer makes which is susceptible to being transferred as a fraudulent transfer, and thus, an incomplete gift. This is an unreasonable conclusion and one that could enable taxpayers to argue that any gift the Service seeks to tax are incomplete transfers. Just because a transfer could be deemed to be fraudulent and therefore available to creditors, would suggest no transfer is complete until the statute of limitations on a challenge has tolled. That is not a reasonable interpretation and certainly has not been followed by the Service.

An Illinois case also ruled unfavorably on the use of a self-settled trust.[5] The following simplified time line of the facts in the Rush U case and Robert W. Sessions ("Sessions") activities, will be helpful to understanding the case.

- February 1, 1994 – foreign asset protection trust established and funded with family limited partnership ("FLP") interests.
- Fall 1995 - Sessions made a pledge to a local charity.
- April 19, 2005 - Sessions created a revocable trust and contributed his 1% general partnership interest to the trust.
- April 25, 2005 Sessions died.

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[4] *Battley v. Mortensen*, Adv. D. Alaska, No. A09-90036-DMD, May 26, 2011

[5] Rush Univ. Med. Center v. Sessions, ____ N.E. 2d ____, 2012 IL 112906, 2012 WL 4127261 (Ill, Sept. 20, 2012). Portions of this discussion were adapted from an article published in LISI by Martin M. Shenkman and Gideon Rothschild.

On February 1, 1994 Sessions, as grantor, established the Sessions Family Trust in the Cook Islands as a foreign asset protection trust ("FAPT"). The FAPT was irrevocable and included a "spendthrift" provision. The FAPT distribution standards permitted the trustees to make distributions to Sessions of income or principal of the trust for his "maintenance, support, education, comfort and well-being, pleasure, desire and happiness." Sessions himself was named Trust Protector of the FAPT. In this capacity, he retained the power to remove trustees, to veto any discretionary actions of the trustees and the power to appoint or change beneficiaries in his will. Sessions transferred 99% of his FLP and property located in Hinsdale, Illinois, aggregating $19 million, to the FAPT.

In the fall of 1995 Sessions made a pledge to a local charity, Rush University Medical Center ("Rush U"), of $1.5 million. The pledge was for the construction of a new president's house on the university's campus in Chicago. In reliance on his pledge the charity built the house and held a public dedication honoring Sessions. Sessions executed several codicils to his will reflecting that any portion of the pledge that was unpaid at his death should be paid from his estate.

On September 30, 1996 Sessions sent Rush U another letter confirming the charitable pledge he had made. Thereafter, Sessions was diagnosed with cancer and blamed Rush U for its failure to discover the cancer early on. Sessions died on April 25, 2005. On December 15, 2005 Rush U filed an amended complaint against Sessions' estate to enforce the pledge. The third count in the complaint relied on the principle that if the settlor creates a trust for his own benefit it is void as to existing and future creditors and that those creditors can reach his interest in the trust. This common law rule was supported by a number of Illinois cases.[6]

The court stated the common law rule as follows, noting that it did not require that the transfer be a fraudulent conveyance: "Traditional law is that if a settlor creates a trust for the settlor's own benefit and inserts a spendthrift clause, the clause is void as to the then-existing and future creditors, and creditors can reach the settlor's interest under the trust." The trustees of the FAPT argued that the common law principal stated above was supplanted by the Fraudulent Transfer Act ("Act") and that the Act provided specific mechanisms to prove that a transfer was fraudulent. The complaint filed by the charity, however, did not allege "that the decedent made a transfer to the trusts 'with actual intent to hinder, delay, or defraud'." The trustees advocated that the Act superseded common law rights that might have made a transfer to a self-settled trust considered to be a fraudulent transfer per se, and hence void. If the Act did supersede the common law, then the charity Rush U, would have to prove that the funding of the trusts was a fraudulent conveyance under the Act. The appellate court reversed the lower court and held that the common law cause of action was abrogated by the UFTA.[7] The appellate court found that if the legislature intended self-settled trusts to remain per se fraudulent under the common law, it

[6] Marriage of Chapman, 297 Ill. App. 3d 611, 620 (1988), and Crane v. Illinois Merchants Trust Co., 238 Ill. App. 257 (1925.

[7] 740 ILCS 160/1 et seq.

would not have promulgated a statue defining the conditions required to prove a transfer was fraudulent.

There is no clarity in the facts presented in the case whether Sessions had inadequate assets when he made the charitable pledge. The facts seem to indicate that Sessions may have had appropriate intent to benefit the charity, and only after his cancer was misdiagnosed by Rush U did he opt to endeavor to avoid the pledge. Unfortunately, as noted above, the Illinois Supreme Court had no alternatives to finding Sessions liable because the charity's complaint did not allege a fraudulent conveyance under the Act. So absent finding a common law remedy as the Supreme Court held, the FAPT would have been relieved of any liability.

The Illinois Supreme Court held that common law creditor rights and remedies remained in full force, even after enactment of the UFTA in Illinois, unless expressly repealed by the legislature, or modified by court decision. The reasoning of the Supreme Court can be summarized in its quote from a case from 1898 "…it would make it possible for a person free from debt to place his property beyond the reach of creditors, and secure to himself a comfortable support during life, without regard to his subsequent business ventures, contracts or losses." There is certainly no assurance that a court in another state would take a similar view of the law.

Many state courts have held that self-settled trusts are accessible to creditors. There is precedent in New York and New Jersey that a self-settled trust is void as against public policy. But there are no cases analyzing the application of this with respect to a self-settled trust state, like Alaska, Delaware, South Dakota or Nevada. If your client lives in one of the states permitting self-settled trusts, then your client can likely use a DAPT. If your client, however, does not reside in one of those states, then there may be an issue, but how much of an issue remains unclear for several reasons.

Courts have remained critical of DAPTs, because judges are generally unfamiliar with how these trusts work, and often have an unfavorable attitude when the law of a jurisdiction outside of the judge's reach and command are used to protect assets that may have significant relationships with the jurisdiction where the judge is located. For example, in the 2013 Bankruptcy Court decision of *Huber*, a bankruptcy judge in Washington State held that Washington State law, in lieu of the protective Alaska law, applied where the debtor had established an Alaska LLC and placed Washington State real estate into the LLC, and then transferred the ownership of the LLC to an Alaska Creditor Protection Trust.

A key issue for DAPTs is whether protection provided by these trusts will be afforded to settlors not residing in those states? What protection, if any, is available for someone residing in a non-DAPT state that creates a DAPT in a state permitting such trusts?

The Restatement of Conflicts of Law Section 273 concerning restraints on alienation of trust interests creates a further issue for DAPTs. This provides that the local law of the state in which the settlor has manifested an intention for the trust to be governed should control. But Section

270 of the Restatement provides that an inter-vivos trust is valid under the local law of the state designated, provided that application of its law does not violate a strong public policy of a state which has the most significant interest in the trust. This could imply that the non-DAPT state may successfully maintain that a DAPT created by its resident to escape creditors in its jurisdiction violates a strong public policy of that state. This interpretation could obviate the benefits of a DAPT for a resident of a non-DAPT jurisdiction. The Uniform Voidable Transactions Act raises further concerns. Section 4 comment 2. Might make a DAPT voidable per se for a non-DAPT resident. **Example**: A resident of New Jersey (which does not permit self-settled trusts) creates a DAPT in Alaska (the first state to permit self-settled trusts), New Jersey courts may permit creditors to reach that trust as being void per se.

The issues set forth above for DAPTs cause many planners to conclude that offshore jurisdictions should be used in lieu of domestic ones, but the costs and tax compliance burdens associated therewith are commonly much more than applies for DAPTs. Many DAPTs are structured to provide that there will be an automatic transfer of the trust to an offshore jurisdiction in the event of any challenging circumstances, and the laws of many offshore jurisdictions provide that the statute of limitations that applies there for a trust moved from another jurisdiction begins when the trust was originally formed. Nevis now has statutes that require a creditor challenging a Nevis trust or Nevis LLC to deposit $100,000 per challenged entity into the court registry, and provides that tenancy by the entireties assets conveyed to a Nevis Trust retain their character as tenancy by the entireties.

In addition, the DAPT may be structured to not include the Grantor as a beneficiary unless unforeseen circumstances occur, such as if the Grantor's net worth, which may include consideration of creditor exempt assets and assets owned by and with a spouse so long as the parties are married. Some planners prefer to have an independent party given a power to add beneficiaries to the trust, which may include the Grantor.

Conclusion

Although asset protection trusts are a valuable asset protection technique, it is important for clients and practitioners to know that there are other less expensive and less complex mechanisms that can be put into in place to provide valuable creditor protection. In many situations a combination of such methods, which may also include the use of an asset protection trusts may also be considered. The asset protection continuum introduced in this article will hopefully help practitioners guide all clients through a range of asset protection planning that will help each client achieve a level of protection that is appropriate for that client's circumstances and budget.