

# BAKER TILLEY ESTATE PLANNING CONFERENCE

ASSET PROTECTION PLANNING:

DOMESTIC AND OFFSHORE PLANNING STRATEGIES  
FOR THE PROTECTION OF FAMILY ASSETS FROM CLAIMS  
OF CREDITORS AND OTHER PREDATORS

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# WHY ASSET PROTECTION PLANNING

- Inevitable Periodic Events in the Macro-Economy Make Clients Feel Vulnerable
  - Latest -- Great Recession 2008- 2010
  - Periodic Collapse of Residential and Commercial Real Estate
  - Periodic Crash of Tech Stocks
  - International Policy Crises and Terror Events

# WHY ASSET PROTECTION PLANNING

- Ever-Expanding Theories of Civil Liability, Explosion of Litigation
  - The average American will be sued 5 times
  - The increasing prevalence of litigation to gain leverage in negotiation; because of the cost of defending, to be sued is to lose
  - Tendency of juries to make unreasonably large awards against defendants perceived to have deep pockets or presumed to be insured
  - Inadequacy, expense of liability insurance, worries that insurer will refuse to cover

# WHY ASSET PROTECTION PLANNING

- Desire to isolate hazards of one business or investment from unrelated assets and activities
- A means to rebuild wealth free from past or current problems
- An alternative to a prenuptial agreement
- Desire to provide assets for family members which are not susceptible to claims of family member's spouse (in divorce) or other creditors

# APPROPRIATE CANDIDATES FOR ASSET PROTECTION

- Macroeconomic developments periodically create new classes of asset protection clients, e.g.,
  - Enron, MCI Directors
  - Arthur Anderson Partners
  - Dewey & Le Boeuf Partners
  - Commercial real estate developers & lenders
  - Wall Street wizards
  - Leveraged and margin investors
  - North Dakota oil-boom investors

# APPROPRIATE CANDIDATES FOR ASSET PROTECTION

- Specific circumstances put client in jeopardy.
  - Claim-prone line of business, e.g., obstetrician
  - Contract or loan commitment may not be able to be met in the future
  - Concerned about possible future divorce
  - HNWI concerned that his wealth and/or notoriety makes him a target for claims

# APPROPRATE CANDIDATES FOR ASSET PROTECTION

- Entrepreneur who has or will sell the shares of his business to a larger company, whose contract will require exhaustive warranties and representations worried about:
  - Buyer mismanagement
  - Buyer regret
  - Macroeconomic factors that may cause sold business to underperform
  - Buyer's huge law firm, which may try to bury him in legal fees to recover price paid for alleged breach of warranty or representation

# INAPPROPRIATE CANDIDATES FOR ASSET PROTECTION

- Insolvent (Liabilities greater than assets)
- Bankrupt or on the verge
- Sued for material damages or judgment entered against him

# ASSET PROTECTION SHOULD BE AN INTEGRAL AND INTEGRATED PART OF THE OVERALL ESTATE AND FINANCIAL PLAN

- Common Sense
- Provides best argument to rebut the suggestion that the planning was motivated by intent to hinder, delay, or defraud creditors
- Be prepared to offer a justification **OTHER THAN** asset protection
- Purpose should be to plan against a possible future event that would result in financial devastation to client's estate

# OTHER BUSINESS PURPOSES FOR ASSET PROTECTION STRATEGIES

## EXAMPLES:

- Probate Avoidance
- Minimization of Income or Estate Taxes
- Confidentiality of Value and Nature of Assets, Dispositive Plan
- Management of Affairs in the Event of Disability
- Preservation of Assets for Dependent Family Members

# WHAT IS FRAUDULENT CONVEYANCE

State laws and Federal Bankruptcy law recognize that a transfer of assets made with intent to hinder, delay, or defraud existing or anticipated future creditors of the transferor may be disregarded and voidable.

However, the law recognizes the right of individuals to arrange their affairs to limit their possible liability to unanticipated future creditors, e.g., prophylactic transfers to protect against a potential future hazard.

# INTENT TO DEFRAUD IS PRESUMED AND NEED NOT BE PROVEN

If the transfer is a gift (for no consideration) and the transfer renders the donor insolvent.

# FRAUDULENT CONVENYANCE IN BANKRUPTCY

A bankruptcy trustee may generally challenge as fraudulent transfers within 2 years of the filing.

There is an extended 10-year look-back period for a bankruptcy trustee to challenge transfers to self-settled spendthrift trusts (of which seller is among the class of beneficiaries), i.e., all domestic asset protection trusts in the 15 states that recognize them other the Oklahoma and “other similar devices.”

# EXEMPTIONS FROM CREDITOR CLAIMS: STATE LAW

- Every state has different exemptions, e.g.,
  - Florida and Texas exempt the “homestead”
  - Retirement plans: some exempt IRAs, some not, some exempt IRAs only to the limit in Federal Bankruptcy
  - Tenants by the Entirety property, if claim is against only one spouse
  - Partnership and multi-member LLC interests

# EXEMPTIONS FROM CREDITOR CLAIMS: Federal Law/Bankruptcy

- All ERISA plans
- IRAs to \$1 million, indexed for inflation
- Rollovers from ERISA plans are completely exempt
- State homestead exemption limited to \$125,000 if home purchased within 40 months of bankruptcy (except to the extent value was derived from sale of prior home in same state.)

# ASSET PROTECTION TECHNIQUES

- Tenancy by the Entirety Property
  - In some states only real property
  - In other states also intangible personal property, i.e., cash and securities
  - In some states -- DC, Maryland and Virginia -- creditors of one spouse cannot attach T by E property

# ASSET PROTECTION TECHNIQUES

- Outright Gifts
  - Beware of federal gift tax
  - Removes assets from donor's income and estate tax returns; also removes future appreciation
- For Minors consider
  - Paying tuition
  - UTMA accounts
  - Section 529 plans

# ASSET PROTECTION TECHNIQUES

- Creation and Transfers of Interests in Family LLCs (and Partnerships)
  - Perfect for pre-IPO stock and predevelopment real estate with low gift tax valuations
  - Transfers of minority interests subject to further gift tax valuation discounts (maybe 30%), permitting leveraged gifts
  - Multi-Member LLC and partnership interests are creditor-protected, cannot be attached, only remedy of creditors is charging order

# ASSET PROTECTION TECHNIQUES

- FAMILY LLCs ... (Continued)
  - Creditor with charging order may receive K-1 and have to pay tax on undistributed income (Rev.Rul. 77-13)
  - Even majority interest held at death by donor eligible for estate tax valuation discount (maybe 20%)
  - Certain states have LLC statutes which afford more protection against creditors of a member, e.g. Delaware, Virginia, Ohio. See the answers to Q. 33 in David Shaftel's ACTEC comparison of Domestic Asset Protection Trust Statutes (attached).

# ASSET PROTECTION TECHNIQUES

- FAMILY LLCs (continued)
  - Consider family partnership tax rules, IRC Section 704 (e) and estate freeze rules, IRC Sections 2701-2704
  - Only way to give away asset for transfer tax purposes but retain practical control (as manager)
  - If it holds only liquid investment assets modest valuation discount for minority interests
  - For all of these advantages, “Holy Grail” of Family Estate Planning

# ASSET PROTECTION TECHNIQUES

- Gifts to Irrevocable “Spendthrift” Trust
  - Subject to gift tax
  - Annual exclusion available if Crummey withdrawal powers granted and administered properly
  - Removes income from donor’s income tax returns
  - Removes assets from donor’s estate
  - Protects assets from creditors claims unless proven to be fraudulent conveyance
  - Affords management by trustees of assets gifted

# ASSET PROTECTION TECHNIQUES

- Gifts to Irrevocable “Spendthrift” Trust (continued)
  - May be used to protect cash value of life insurance in insurance trusts
  - May be used to protect transferred assets from creditors of trust beneficiary, e.g., from spouse in divorce
- Gifts to Revocable Trusts
  - Ineffective for asset protection

# ASSET PROTECTION TECHNIQUES

- Gifts to Charity
  - Creditors cannot reclaim unless fraudulent conveyance. Charities will fight creditor claims
  - But annuity on CRT may be attached
  - Remainder of CLT may be attached

# ASSET PROTECTION TECHNIQUES

- Life Insurance

- If premiums are paid with intent to defraud creditors of the insured, the premiums may be recovered by creditors.
- If a policy is transferred with intent to defraud creditors of the insured, the cash value of the policy may be liable to creditors' claims.
- In general and in Virginia, upon the demise of the insured, even if fraudulent conveyance of premium payments is proven, creditors have no claim to death benefits except to recover premiums paid.

# ASSET PROTECTION TECHNIQUES

- Life Insurance (continued)
  - Some state statutes exempt life insurance cash value from bankruptcy creditors, e.g., in Maryland when paid to spouse and/or children.
  - It is possible to purchase life insurance in certain offshore jurisdictions, such as The Bahamas and Cayman Islands, where the cash value is expressly not subject to claims of creditors.

# SALE OF ASSETS TO A CHILD OR TO A TRUST FOR A CHILD

- If for full and adequate consideration, difficult to show fraudulent intent.
  - Useful technique for
    - Pre-development real estate
    - Early stage tech investment
    - Family business
- to protect future appreciation from creditor claims.
- Use of long-term installment sale further frustrates creditors.

# “UGLIFICATION” OF ASSETS

- It is frequently a more subtle, difficult-to-attack means of asset protection to RETAIN an asset but make it UNAPPEALING to creditors.
- EXAMPLES
  - QPRTs: a grantor parent retains the right to use a personal residence for a period of years, after which title jumps to children. While a creditor of parents may get at the retained term interest, that is not particularly attractive, and the creditor cannot defeat the reversion unless it can show a fraudulent conveyance. What a creditor wants to do is seize and sell the real estate.

# “UGLIFICATION” OF ASSETS

- GRAT: grantor parent retains the current value of any asset expected to appreciate but gives away the future appreciation. Unless the creditor can show fraudulent conveyance, the future appreciation is protected.

# “UGLIFICATION” OF ASSETS

- Other Examples
  - Encumber a property attractive to creditors and reinvest the borrowed equity in a protected structure, e.g. family LLC, or
    - give cash to family members or a trust for them, from which settlor could later borrow funds
    - purchase life insurance in an irrevocable trust
    - contribute to a protected retirement plan
    - Invest in an offshore asset protection trust.
  - Invest exposed cash or liquid assets in a protected structure as above or pay down the mortgage on a protected tenants by the entirety property

# QUALIFIED RETIREMENT PLANS

- ERISA plans: defined benefit, defined contribution, e.g., 401(k) plans are COMPLETELY protected from creditor claims, even in bankruptcy, unless fraudulent conveyance may be shown: Patterson v. Shumate (US Supreme Court)
- IRA plans, which are NOT ERISA plans, may be protected
  - fully protected if rolled over from ERISA plan
  - up to \$1 million, indexed, under federal bankruptcy law
  - otherwise as provided by state law and state bankruptcy exemptions

# OPERATING BUSINESS

- Incorporation as C or S Corporation or LLC and rigorous observance of corporate formalities should protect shareholders from personal liability on business obligations.
- Directors and officers should seek broad indemnification from the corporation and possibly require D & O liability insurance, or reimbursement for such premiums paid directly by directors or officers. Chubb will sell policies to officers and directors.

# LIABILITY INSURANCE/UMBRELLA

- The first line of defense against creditors should be adequate auto and homeowners liability insurance backstopped by a significant (\$2-\$10 million) umbrella policy from a reputable company.
  - HNWI prefer Chubb. It is known to stand and fight, e.g. Chubb defended Bill Clinton from Paula Jones sexual harassment claim, O.J. Simpson from wrongful death claim of Ron Goldman, under umbrella policies.
- For automobiles, we recommend that husband own and use his auto, wife own and use hers, so if one has a crash, assets of the other spouse and tenants by the entirety assets should not be exposed.

# AVOIDING INHERITANCE IF FACING POTENTIAL LIABILITY

- If a spouse or child is facing a potential claim, structure estate plan to provide for them via discretionary spendthrift trusts, which are immune to creditor claims.
- A disclaimer of an inheritance by one with creditors may or may not be challenged as fraudulent conveyance, based on state law.

# MARITAL AGREEMENTS AS A SHIELD

- If a spouse wishes to be protected from liabilities arising from a spouse's business – e.g., from liability on performance bond in a construction business or from any kind of obligation to co-sign or co-guarantee a business loan, a pre- or post-nuptial agreement may assure the spouse freedom from such a liability.
  - May also be used to keep the family home free from a business debt related encumbrance.
  - Having such marital agreement in place will often permit the spouse operating the business to secure financing without the other spouse's involvement, whereas a bank or lending company will always try to get a spouse to co-sign.

# PLANNING FOR SPOUSAL CLAIMS IN DIVORCE

- First line of defense: Pre- or post-nuptial agreement
  - Requires (a) full disclosure of balance sheets and income statements of each and (b) separate counsel for each
- Many asset protection engagements focus on potential future divorce claims.
- Beware of ethical conflicts and fraud claims: if you have been engaged by both for any purpose, you probably cannot/should not represent or advise either against the other.

# PLANNING FOR SPOUSAL CLAIMS IN DIVORCE

- What may a spouse do if no divorce suit is currently anticipated?
  - Offshore asset protection trust with solely owned assets but not community property
  - Keep inherited and gifted assets in separate name (not part of the Marital Estate – assets earned during marriage – subject to division in divorce)

# PROTECTING FROM SPOUSAL CLAIMS IN DEATH

- Most states protect spouses of decedents by guaranteeing them one-third of predeceased spouse's estate.
  - In some states this right applies only to assets passing under the Will, and so may be circumvented by beneficiary designations, joint ownership, or passing assets by revocable trust.
  - More states expand the right to non-probate assets.
  - Depending on state law there may or may not be any way to circumvent the requirement other than a pre- or –post- nuptial agreement.

# PROTECTING FROM SPOUSAL CLAIMS IN DEATH

- Civil law jurisdictions – France, Germany, Italy, etc.– frequently negate freedom of testation and require that a certain portion passes to the spouse, the balance to children.
- Sharia law requires more to pass to sons than daughters.
- U.S. or foreign clients may establish trusts offshore in jurisdictions which will not enforce “forced heirship” laws.
- This is a common reason to establish offshore trusts.

# SPENDTHRIFT TRUSTS AVOID CREDITORS OF BENEFICIARIES

- Normally a creditor has no right to get at the assets of a discretionary “spendthrift” trust established for a debtor.
- Such properly drafted trusts are effective against divorce claims, governmental claims for a child eligible for safety-net governmental benefits, and most tort claims.
- Perfect examples are typical credit-shelter trusts fbo surviving spouse and children, then subdividing into perpetual trusts for descendants.

# PLANNING TO MAKE ELDERLY MEDICAID ELIGIBLE

- Highly complex topic, but the endeavor is generally ineffective for the middle class and above.
- To be Medicaid eligible, an elderly person must have virtually no assets: less than \$3,000.
- If they try to give away their assets to their children to become eligible, there is a “look back” period of typically 5 years which will disqualify them from eligibility.
- Spouses are generally required to support a spouse in a nursing home.
- The law will not require the at-home spouse to sell the house, but will bill the spouse for unpaid state support when the first spouse dies, so when the house is sold, the proceeds are a source of satisfaction.

# IRS AS A CREDITOR

- Virtually no defense works.

# ASSET PROTECTION TRUSTS (APT<sub>s</sub>)

- Self-Settled Spendthrift Trusts fbo, inter alia, the settlor and his family
- OAPT: Offshore Asset Protection Trust
  - generally established in small English-speaking island jurisdictions, generally where APT legislation has been adopted (about 60 jurisdictions)
- DAPT: Domestic Asset Protection Trust
  - established in one of 14 U.S. states which have adopted APT legislation

# OFFSHORE ASSET PROTECTION TRUSTS (OAPT<sub>s</sub>)

- Irrevocable, discretionary, spendthrift trust established by U.S. citizen or Resident Alien or Non-Resident Alien
- In English common law jurisdiction recognizing self-settled spendthrift trusts fbo settlor and others
- A few do NOT have specific asset protection legislation, e.g. Isle of Man, Channel Islands (Guernsey and Jersey)
- Most do have specific APT legislation, e.g. Cook Islands, Nevis, The Bahamas, Cayman Islands, Bermuda, Liechtenstein
- Alternate scenario: client asks offshore bank to settle the trust and serve as trustee for greater confidentiality

# OAPTs FOR U.S. SETTLORS/TAXPAYERS

- “Foreign trust” for U.S. tax purposes (IRC §7701(a)(30)(E) and (31)(B))
- Grantor trust tax treatment per IRC §679. U.S. Settlor pays income tax
- Transfers to trust “incomplete gifts,” all trust assets subject to U.S. estate tax (“defective” under §2036), so will contain bypass trust/marital trust tax planning. Trust will look like a U.S. revocable trust.
- Perfect tax transparency, numerous filings required: Forms 3520, 3520-A, 8938, FBAR Form TDF-90.221, FATCA disclosures

# OAPTs FOR U.S. SETTLORS/TAXPAYERS

- Will have a “Trust Protector” who may fire and replace trustee, move trust to other jurisdictions
- Settlor will provide Trustee with informal Letter of Wishes
- Assets may be managed in U.S. or offshore, typically in a company or LLC wholly-owned by the trust
- There is no U.S. tax “angle” for U.S. citizens or resident aliens

# OAPT<sub>s</sub>: SELECTING A JURISDICTION

- Political stability
- Asset protection trust statute
- Shorter statute of limitations to challenge
- Less stringent fraudulent conveyance law than U.S., e.g. heavier burden of proof
- Large, stable trustworthy trust company/experienced and credible trust officer
- Willingness to accept your U.S. client
- Will not recognize or enforce U.S. judgment the client is concerned about, or will be reluctant to
- Countenances self-settled spendthrift trusts
- Selection of jurisdiction is art, not science

# OAPTs: WHY THEY WORK

- U.S. courts (including bankruptcy courts) have no jurisdiction over assets in offshore trust if --
  - No assets in U.S.
  - No trustee in U.S.
  - No trust protector in U.S.
- Most offshore jurisdictions will not enforce domestic/divorce and forced heirship/dower laws of other jurisdictions.
- There has NEVER been a successful forcible repatriation to the U.S. of assets held in an OAPT.
- Vulnerability: Settlor can be held in contempt. This is likely a risk only in domestic disputes with bad facts and when U.S. government is the claimant.

# DAPTs FOR U.S. SETTLORS/TAXPAYERS

- 15 states have adopted statutes, 14 permitting self-settled spendthrift trusts
- To date they have not worked. Last 8 court cases have all refused to respect them
- Theory: as more states adopt, courts in those states which have adopted will respect DAPTs of other states
- Practice: Courts of Delaware and Utah, two states with DAPTs, refused to enforce DAPT statutes of other states
- Biggest problem are under U.S. Constitution: Full Faith and Credit Clause, Supremacy Clause, Contract Clause; also Conflicts of Law Principles, sham or alter ego arguments, 10-year claw-back rule in bankruptcy
- Generally grantor trusts and defective gifts, so subject to income tax and estate tax to Settlor

# DAPTs: COMPARATIVE CHART

- A wonderful chart, as of April 2014, comparing and contrasting the DAPT statutes of all 15 DAPT jurisdictions, prepared by David Shaftel, an ACTEC fellow in Alaska, with reporters in each of the 15 states, is attached.

# RISKS TO LAWYERS AND ACCOUNTANTS COUNSELING CLIENTS ON ASSET PROTECTION STRATEGIES

- Civil suit as co-conspirator with client in a fraud
- Malpractice claim; malpractice insurance may not cover
- Ethical complaint
- Contempt of court as co-conspirator
- Criminal fraud charge

# CLIENTS WANT ASSET PROTECTION

- All surveys show that asset protection in general is among the highest priorities of high net worth individuals.
- Advisors who can competently counsel clients regarding asset protection strategies are scarce.