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Asset protection: Insulate your personal property from attack

By **Ryann Whalen, JD,** Partner, Harris Kessler & Goldstein LLC, Chicago.

Editor's note: *Horror stories of physician colleagues losing personal assets in malpractice judgments make the subject of asset protection of particular interest. This issue of* ED Legal Letter *is not intended to be an all-inclusive discussion, but rather an informative primer, thus affording readers valuable information about options for protecting their personal savings and retirement accounts.*

Introduction

Asset Protection Planning. Asset protection planning consists of strategies taken to protect and insulate assets from future creditor attack. While asset protection planning long has been a fundamental component of the savvy physician's estate plan, its techniques have become even more popular in recent years for nonphysicians as juries in the United States issue ever-increasing monetary awards. As a result, the statutory and case law interpreting particular techniques has evolved significantly during the last decade.

Asset protection planning involves a comprehensive inventory of assets held by an individual or a family, along with the manner in which such assets are titled. For this reason, asset protection techniques often are implemented in conjunction with an estate plan. Planning techniques require consideration of the estate, gift, and income tax consequences of a proposed transfer.

Since asset protection is a highly complex area of practice, it strongly is recommended that an individual interested in pursuing such planning consult with experienced advisors. Not only is it necessary to be counseled on the interplay of available asset protection strategies with various conflicts of laws, laws of foreign countries, corporate laws, estate planning, and estate, income, and gift tax ramifications applicable under a particular situation, proper planning will avoid transfers classified as fraudulent.

This article will describe the traditional as well as the more pioneering asset protection planning techniques available; the tax consequences of

various techniques; the pitfalls of a fraudulent transfer; and current legal developments concerning various asset protection planning techniques.

Fraudulent Transfer Laws

The Importance of Planning Today. Because even the most basic asset protection planning typically involves a transfer of assets, a preliminary consideration in any plan is the applicable fraudulent transfer laws.[1] In general, the fraudulent transfer laws prevent transactions made with intent to defraud a particular creditor.[2] If made with the intent to hinder a creditor, a transfer is fraudulent regardless of whether it also may have been motivated by nonfraudulent intentions. By failing to comply with the governing fraudulent transfer laws, an asset protection planning transfer will be void and the individual making the transfer (and possibly his or her attorney or other advisors) may be exposed to civil — and in extreme instances, criminal — liability. In light of this potential liability, most professionals are willing to advise their clients about asset protection only if they are confident that neither a current claim nor a legitimate expectation of a future claim exists.

In determining whether a transfer is fraudulent (i.e., whether the transfer was meant to hinder a present creditor), a court will not necessarily require that the creditor in question have a claim that has been reduced to a judgment. Consider, for example, a surgeon, concerned about the consequences of a particular procedure she performed on a patient, who immediately transfers her investment account to her spouse. A court later reviewing the transfer is likely to classify it as fraudulent because it was made with the intent to hinder access to the investment account. In this example, it is not necessary for the patient to have obtained a judgment or even filed suit against the surgeon to be considered a creditor for fraudulent transfer purposes. By contrast, consider an internist about to form a private practice. While establishing his practice, an attorney advises him to establish an offshore trust to protect his personal holdings from potential professional negligence claims. A subsequent creditor is not likely to succeed on a fraudulent transfer assertion because the trust was not established with a particular creditor in mind **(see table, p. 135)**.

While the previous examples illustrate the advantages of engaging in asset protection strategies before a potential claim arises, there are possible solutions for a client who is faced with existing claims or creditors. A determining factor for a court in ascertaining whether or not a transfer was made with the intent to defraud a particular creditor is the solvency of the debtor. If the debtor became insolvent as a result of the transfer in question, there is a greater likelihood that transfer will be void. Thus, in instances where individuals have an existing creditor or claim, asset protection plans often are structured for the benefit of protection against future creditors while ensuring that the debtor remains solvent with regards to his current creditors.

Traditional Asset Protection Planning Concepts

Business and Corporate Entities. To minimize exposure resulting from business ventures or real estate holdings, individuals routinely are advised to consider an appropriate entity to shield their personal assets from creditor attack. Various types of entities

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can be established to distinguish the assets of the business from the personal assets of the business owner and thereby limit a business creditor's ability to recover from the business owner's individual assets **(see insert)**.

Asset Protection-Planning

As noted above, asset protection and estate planning often operate in conjunction with each other. The following discussion will focus on certain asset protection strategies that are equally popular for their estate planning advantages and their utility in reducing estate tax liability.

Gifts. Gifts of property to family members have long been a staple of any asset protection or estate plan. An outright gift to a spouse or family member not engaged in a high-risk profession has the distinct advantage of removing the gifted asset from claims of future creditors. In addition, a gift has the estate-planning advantage of removing assets from the transferor's taxable estate. Of course, a gift is not a plausible alternative for an individual concerned with relinquishing control and enjoyment of his or her property. In addition, any gifting program must consider gift tax consequences and maximize use of the exemptions available in the Internal Revenue Code.[3] Finally, if a gift is not made to a particular type of protected trust, the gifted asset immediately will be subject to the donee's creditors.

Co-Tenancies. Many individuals (particularly those who purchase real estate in a joint capacity) do not fully appreciate the estate and asset protection consequences of the form of co-tenancy they create. When purchasing a joint asset with another individual, it often is advisable to seek advice surrounding the appropriate form of co-ownership.

Joint Tenancy with Right of Survivorship. Property held in joint tenancy with right of survivorship, traditionally popular for convenience reasons (in that it will pass directly to the surviving joint tenant without the necessity of probate by virtue of the survivorship feature), provides no asset protection. In fact, joint tenancy with right of survivorship exposes the property to the creditors of each joint tenant. In addition, negative estate planning and estate tax consequences can result from this form of ownership, particularly when it is used to hold property between persons not married to each other.

Tenancy by the Entirety. Any discussion of asset protection would be incomplete without consideration of the availability of tenancy by the entirety under the applicable state statute. Tenancy by the entirety is a very popular, cost-effective form of ownership that often can protect a family's most valuable asset. Tenancy by the entirety is a specific form of joint tenancy that can exist only between a husband and wife. Like joint tenancy with right of survivorship, upon the death of one spouse the entire property held in tenancy by the entirety will pass to the surviving spouse pursuant to a survivorship feature. However, in states that recognize tenancy by the entirety, the property is treated as being owned by the marriage and, therefore, the law prohibits a creditor of one spouse from executing upon property held in tenancy by the entirety to satisfy

Table. Legitimate Transaction or Fraudulent Transfer?

Transfers made as part of an estate plan to children by an individual who was a guarantor on a loan were not fraudulent because they were based on a plan before knowledge of liability.[1]

Transfers were fraudulent when the debtor was allegedly attempting to equalize the estate for himself and his wife for estate tax purposes where at the time of transfer the debtor's liabilities appeared to exceed his assets. The timing of the transfers in close proximity to the debtor incurring increased personal liabilities and the debtor's insolvency at the time of transfer were sufficient to support the assertion of fraud.

A conveyance made without fair consideration by a defendant in an action for money damages or by a judgment debtor is deemed to be fraudulent automatically if the defendant fails to satisfy the judgment.[2]

The debtor purchased two homes and subsequently transferred the homes to his wife's individual name with no consideration. At the time of purchase and transfer, the debtor's liabilities exceeded his assets. Both the debtor and his wife were signatories on the mortgage for one of the homes. The debtor, however, made the mortgage payments and paid for the expenses and improvements on the residences. The court held that because the debtor continued to retain the possession, benefit, and use of the properties and treated them as his own, he had intent to defraud.[3] "The transfer of property by the debtor to his spouse, while insolvent, while retaining the use and enjoyment of the property is a classic badge of fraud."[4]

References

1. In re *Atkinson,* 63 BR 266, 270 (Bankr. WD Wis. 1986).
2. N.Y. Debt & Cred. Law § 273-a.
3. In re *Kaiser,* 722 F.2d 1574 (2nd Cir. 1983).
4. In re *Kaiser* at 1583.

a judgment. In some states that recognize tenancy by the entirety, only real estate or a primary residence can be held in tenancy by the entirety.[4] In addition, there are states that recognize tenancy by the entirety for real estate and personal property.[5]

In states that recognize tenancy by the entirety for real estate only, a common strategy is to minimize any mortgage in an effort to maximize the equity of the protected asset. There is no gift tax consequence upon creation of a tenancy by the entirety if both spouses are U.S. citizens because of the unlimited martial deduction allowing tax-free transfers between spouses.[6]

Transfers to Tenancy by the Entirety. There are instances of authority (both statutory and case law) that provide that a transfer to tenancy by the entirety is not a fraudulent transfer even if a creditor of one spouse has a judgment against him or her.[7] For example, in Illinois, where tenancy by the entirety is limited to homestead property, courts and the legislature have determined that provisions of the Fraudulent Transfer Act are not applicable to transfers into tenancy by the entirety.[8] An Illinois appellate court held that a creditor can void a transfer of property to tenancy by the entirety if the transfer was made with an intent to defraud a particular creditor.[9] The Illinois General Assembly amended the tenancy by the entirety statute to provide that if the property was transferred into tenancy by the entirety with the sole intent to avoid the payment of existing debts, the protections of the statute did not apply.[10] Thus, under the amended Illinois statute, the actual intent standard contained in the Fraudulent Transfer Act could not be used to set aside a transfer of property to tenancy by the entirety. The amended tenancy by the entirety statute expressly included its own standard to be used when a creditor challenges a transfer. That standard is whether the transfer occurred with the sole intent to avoid payment of debts existing at the time of transfer.

The sole intent standard is in contrast to the actual intent standard of the Fraudulent Transfer Act. Under the Fraudulent Transfer Act, a creditor may void a transfer if the debtor made the transfer with the actual intent to hinder, delay, or defraud the creditor. Under the sole intent standard if the transfer occurred to place it beyond the reach of creditors and for some other legitimate purpose the transfer would not be voidable because the transferor had some motivation other than avoiding a creditor's claim. For example, an individual who is a judgment debtor marries and is desirous of placing his spouse's name on the title to his home would presumably make the transfer of the property to tenancy by the entirety without the sole intent to defraud his judgment creditor. There would also be the legitimate purpose of including his spouse in the title. In this example, such a transfer would be voidable under the standard set forth under the fraudulent transfer law because the transferor had the actual intent to avoid creditor claims despite any other motivation. However, the Illinois statute is demonstrative of legislative attempts to provide marital homestead property held in tenancy by the entirety with greater protection from creditors by removing it from application under the Fraudulent Transfer Act. [11]

A Caution Regarding Tenancy by the Entirety. Tenancy by the entirety is routinely employed when both spouses are subject to personal liability as a result of their professions. However, it is important to note the potential temporary nature of tenancy by the entirety. For example, the death of one spouse will immediately expose the property to the creditors of the surviving spouse. In instances where only one spouse is employed or routinely is exposed to liability, married individuals often are counseled to transfer real estate and other assets to the nonworking spouse. Through the creation of a particular type of marital trust, the nonworking spouse's estate plan can provide for the residence to pass to a trust that will, in large part, protect the asset from the survivor's creditors.

In addition, a recent Supreme Court case demonstrates the potential fallibility of tenancy by the entirety as a defense to a federal claim. The Supreme Court recently found that a tenancy by the entirety was not a sufficient barrier to attachment by the IRS for the value of a federal tax lien against one spouse.[12] Despite the fact that Michigan law provided that tenancy by the entirety could not be the subject of a fraudulent transfer when only one spouse is a debtor and despite the fact that courts traditionally have held that federal tax liens could not attach to property that cannot be unilaterally alienated, in *U.S. v. Craft,* the Court found that Mr. Craft had significant rights in the property which would allow the lien to attach.

Tenancy In Common. Unlike joint tenancy and tenancy by the entirety, tenancy in common provides no survivorship feature, and at the death of one joint tenant, disposes of his or her interest according to the co-tenant's estate plan. This form of ownership provides minimal asset protection. A creditor of a debtor co-tenant can reach the debtor's interest in the property. As a practical matter, however, the

creditor will not receive full enjoyment of the property because the creditor will be subject to the other tenants in common and often will be forced to seek a judicial partition of the property. The gift or estate tax consequences of a tenancy in common depend on the relationship between the co-tenants and the amount contributed by each owner.

Planning with Conventional Trusts

In addition to their efficacy in the estate-planning context, both domestic trusts and offshore trusts are common asset protection vehicles. A domestic trust is one that is governed by and administered under U.S. state laws. When viewed for their asset protection abilities, the utility of a domestic trust generally centers on: 1) who created the trust (often referred to as the "settlor"); 2) who is the beneficiary of the trust; and 3) what rights the settlor provided for the beneficiary or retained in the trust instrument. It is generally well established that a self-settled trust, meaning a trust for which the settlor has created for his or her own benefit, will achieve no protection from creditors.[13] Due to the marketing efforts of some attorneys and financial advisors promoting the benefits of so-called revocable living trusts or self-declarations of trust, many individuals incorrectly assume that such trusts offer asset protection. While revocable trusts are valuable estate planning devices, they provide no asset protection for the settlor who remains the lifetime beneficiary. Thus, the following discussion of the asset-protection benefits of protective trust provisions is only applicable in situations where the settlor has established an *irrevocable* trust for a beneficiary other than him or herself. In general, a gift or transfer to an irrevocable trust will have gift tax consequences because the settlor/donor has removed the trust assets from his or her taxable estate and has relinquished control over the assets.

Protective Trust Provisions. Often one of an individual's most important estate planning objectives is to shield the inheritance of an intended beneficiary from personal liabilities such as professional negligence claims, personal creditor claims, alimony and child support claims, personal tort liability, and personal tax liabilities. So-called protective trust provisions are available to effectuate an individual's objectives in this regard.

For example, a discretionary trust is one in which the trustee has complete discretionary authority over whether to distribute trust income and principal to a beneficiary. Sample language of a broad discretionary trust provision is set forth below:

> *The trustee may distribute to any one or more of the trust beneficiaries from time to time then living, so much or all of the net income and principal of the trust, in equal or unequal proportions and at such time or times as the trustee, in the trustee's sole discretion, deems appropriate for the health, support, education, maintenance, or best interests of any one or more of the trust beneficiaries, adding to principal any income not so distributed. In making such a determination, the trustee may consider any other sources of income and means of support available to the beneficiaries, individually and as a group, and any other circumstances and factors which the trustee, in the trustee's sole discretion, deems pertinent.*

The advantage of such discretionary language is to limit the beneficiary's interest under the trust. In general, the beneficiary's interest under the trust only exists when and to the extent that the trustee decides to make a discretionary distribution to the beneficiary. Since the beneficiary has no right to compel the trustee to make a distribution to the beneficiary, a creditor of a beneficiary whose trust interest is subject to such trustee discretion generally cannot reach the underlying trust assets, nor can the creditor force the trustee to pay out income or principal to the trust beneficiary. Generally courts only will interfere with a trustee's exercise of discretion when it is determined that the trustee has abused its discretion.[14]

Another common protective trust provision is a spendthrift clause. A spendthrift trust provides a restraint on the voluntary or involuntary alienation of a beneficiary's interest in a trust that can provide significant protection for the trust beneficiary.[15] Sample language of a spendthrift trust provision is set forth below:

> *Trust income and principal shall be for the sole use and benefit of the trust beneficiaries named herein. No trust beneficiary shall have the right to sell, transfer, assign, pledge, mortgage or otherwise encumber any part of the beneficiary's interest under the trust. No trust income or principal shall be subject to the claims of any creditor of a trust beneficiary. No trust income or principal shall pass to any receiver (for the benefit of the creditors) or to any trustee of a beneficiary in bankruptcy.*

Of course, regardless of the protective provision

contained in a trust, once a trustee makes a determination to distribute trust assets to a beneficiary, that distribution is subject to creditor attachment. Moreover, a properly drafted trust will allow the trustee to make distributions for the benefit of the beneficiary (i.e., to an educational institution or medical provider), thereby eliminating an instance where the distribution is exposed to the beneficiary's creditors.

Marital Trusts. A simple yet effective asset protection plan for a physician spouse and a nonworking spouse may center on the transfer of the individual assets of the physician spouse to the nonworking spouse (or a working spouse not exposed to professional negligence claims). As noted above in the tenancy by the entirety discussion, it is equally important to address a situation where the nonworking spouse predeceases the physician spouse. If the physician spouse inherits assets directly (free of trust, in his or her individual name) from the nonworking spouse, such assets could be exposed to the physicians' professional negligence claims.

This situation is typically mitigated through use of a Qualified Terminable Interest Property (or "QTIP") marital trust. A QTIP marital trust is a trust that qualifies for the unlimited marital deduction (provided that the surviving spouse is a U.S. citizen).[16] *Income* from a QTIP trust must be distributed to the surviving spouse at least as often as annually, thereby making the income distributions available to creditors. However, the *principal* of the trust can qualify for spendthrift or discretionary trust status. In the foregoing example, a QTIP trust would be incorporated into a nonworking spouse's estate plan so that upon his or her death, the physician spouse's inheritance will pass to a QTIP trust. It should be noted that an alternative to a QTIP trust is available for spouses who are not U.S. citizens.[17] QTIP marital trusts also can facilitate lifetime gifts between spouses.

Other Trust Planning Opportunities. It is important to mention that more advanced trusts that facilitate large transfers of wealth from one generation to another with reduced estate and gift tax consequences also can provide effective asset protection opportunities. Such trusts are those in which the settlor makes an irrevocable gift of the trust property while retaining an interest in a portion of the trust property.

Because the settlor retains a portion of the trust assets, the IRS recognizes the gift is something less than the entire trust corpus and allows a settlor to often obtain a substantial discount on the value of the transfer. Examples of the types of trusts that are well known for their ability to provide "leverage" in a gifting program include Qualified Personal Residence Trusts (QPRTs), Grantor-Retained Annuity Trusts (GRATs), and Charitable Remainder Trusts (CRTs). At least one commentator suggests these types of trusts in lieu of an offshore or more obvious "asset protection" trust as an attempt to counter fraudulent transfer claims. Thus, the argument is that since these trusts are commonly used in the estate-planning context, they are more likely to survive scrutiny in a fraudulent transfer setting than would for example, an offshore trust.[18] In addition to GRATs, QPRTs, and CRTs, an irrevocable life insurance trust, a routine estate-planning device, often is advisable to protect the cash value of a life insurance policy and its proceeds.

Disclaimers. A longtime "postmortem" planning concept with relevance in asset protection planning is a disclaimer or a renunciation. A disclaimer is a refusal to accept an inheritance. The law recognizes that a person is not obliged to accept an inheritance and therefore permits individuals to disclaim property so that it passes as if the individual predeceased the person from whom they would have inherited the property. Disclaimers often are used in the estate-planning context to avoid taxation of an inheritance in an individual's estate and are effective for such purposes if the "disclaimant" (the individual renouncing his or her inheritance) never accepted an interest in the gift.[19]

In the asset protection context, a disclaimer may be considered where a family member dies leaving a bequest to a beneficiary with creditor problems and there is a concern that the inherited property will be exposed to the beneficiary's creditors. However, the efficacy of a disclaimer in this situation is questionable. Some state statutes expressly provide that a disclaimer will not be effective for asset protection purposes if the disclaimant is rendered insolvent.[20]

A much more secure approach to the above situation is for an individual to plan for receipt of an anticipated inheritance by discussing the provisions of his or her parent or grandparent's estate plan with them and their advisors. If inherited assets pass to a spendthrift or discretionary trust, they will not be subject to the beneficiary's creditors.

Domestic Asset Protection Trusts

As discussed earlier, an individual generally cannot create a trust for his or her benefit and protect the assets from creditors. However, in recent years,

several states (Alaska and Delaware were among the first) have enacted legislation that purport to protect self-settled trusts from creditor attachment.[21] Thus, these states have essentially set out to create what is achieved through an offshore trust arrangement.

Alaska's trust act[22] provides that assets transferred to a trust containing spendthrift provisions are protected from creditors unless the intent was to defraud creditors or the transfer renders the settlor insolvent. There are several other limitations placed on these trusts. The settlor cannot retain the power to revoke or terminate all or part of the trust without the consent of a person who has an adverse interest in the trust; the transfer could not have been intended to hinder, delay or defraud creditors; the trust cannot have a mandatory requirement that all or part of the trust income or principal be distributed to the settlor; and the settlor cannot be in default by 30 days or more in child support. For a trust to fall within the purview of Alaska's statute, the trust administration must occur in Alaska, meaning that part of the assets must be in an Alaskan account and the trustee must be an Alaska resident or an Alaska trust company or bank. The Delaware statute[23] is very similar to Alaska's trust act. As in Alaska, a settlor in Delaware may transfer assets to an irrevocable spendthrift trust yet still retain a discretionary beneficial interest if certain requirements are met.

Unlike self-settled offshore trusts, the Delaware and Alaska legislation attempt to make the transfer of property to a domestic asset protection trust result in a completed gift for federal gift tax purposes. If the transfer is deemed a completed gift, then the property is removed from the settlor's estate for estate tax purposes. This is important for asset protection purposes because practitioners have traditionally reasoned that if an asset remains a part of a settlor's taxable estate, it is logical that it is exposed to his or her creditors. The Alaska and Delaware legislations theorize that if the transferor's creditors cannot reach property, the transferor has effectively given up substantial control of the property.

If the transfer to the trust is a completed gift, the trust should be exempt from estate tax on the transferor's death. However, it is possible that the transferor's right to receive distributions may result in the trust assets being includable in the settlor's estate.[24]

Finally, there is a question as to whether these protective trusts actually achieve their stated goals. The U.S. Constitution requires each state to give "full faith and credit" to judgments handed down by the courts of all states.[25] Once the creditor receives a judgment order in any state, there is no need to re-litigate the issues in the state where the assets are held. As of today, there has been no "test" case determining how the Full Faith and Credit Clause affects the enforcement of a judgment against an Alaska or Delaware trust. The uncertainties and the lack of judicial precedent surrounding the Alaska and Delaware trust provisions along with the well established legal principles against self-settled spendthrift trusts in the United States make it currently unknown whether the objectives of the protective trust statutes can be achieved.

Offshore or Foreign Trusts

An increasingly popular asset protection planning device for physicians as well as other wealthy individuals and families is an offshore trust. Offshore trusts and foreign trusts generally refer to trusts that have a minimum of one trustee who is not a resident of the United States. Accordingly, an offshore trust is typically governed by the laws of a foreign country that is selected because of its favorable creditor protection legislation. Commonly utilized jurisdictions include the Isle of Man, the Cayman Islands, and the Cook Islands.

Structuring Offshore Trusts. Offshore trusts are generally governed by foreign jurisdictions favorable to asset protection trusts. In particular, unlike most domestic trusts, such jurisdictions provide protection for self-settled trusts. Foreign trusts are irrevocable but usually provide a third party with a power to amend and the settlor with controls over the trust. Such trusts almost always have one non-U.S. trustee acting at all times (regardless of whether the trust assets are situated in the United States) and the foreign trustee holds the trust powers and in particular the power to distribute income and principal of the trust. Foreign trusts typically contain provisions that allow the foreign trustee the power to change the situs of the trust assets to another jurisdiction if the trust assets are under attack. Clauses known as "duress" provisions direct a foreign trustee to ignore an order of a U.S. trustee if given under duress such as a court order directing the trustee to turn over trust assets.

Offshore trusts are often funded through use of other estate and asset protection techniques such as corporations, family limited partnerships, and limited liability companies. For example, an offshore trust

might hold interests in an LLC situated in the United States. However, funding a foreign trust with any assets that are directly or indirectly located in the United States could subject those assets to the jurisdiction of a U.S. court. Other structures involve funding such a trust with assets of a foreign jurisdiction (which may or may not be the jurisdiction governing the trust).

Advantages of Offshore Trust Arrangements. In recent years, foreign trusts have been heavily marketed by trust companies and financial institutions located in offshore jurisdictions largely for their ability to serve as a deterrent to a creditor or a creditor's attorney attempting to reach the assets of such a trust. For example, an attorney in the United States must confront the legal, geographical, procedural, and financial obstacles associated with the foreign jurisdiction. Obviously, the costs associated with attempting to seize assets of a foreign trust can be high, particularly since many foreign jurisdictions prohibit contingent-fee litigation.

In addition, unlike domestic trusts, as stated earlier, certain foreign laws allow a settlor to effectively create an asset protection trust for his or her own benefit thereby giving the impression that a settlor can "have his cake and eat it, too."[26]

Other favorable aspects of offshore jurisdictions are their tendency toward "pro-debtor" fraudulent transfer laws that generally require a creditor to prove a fraudulent transfer beyond a reasonable doubt. [27]

Disadvantages of Offshore Trust Arrangements. The perception surrounding foreign trusts often results in a misconception that they offer "tax avoidance" advantages. Instead, foreign trusts are neutral for estate, gift, and income tax purposes for individuals residing in the United States.

Because of the flexibility of self-settled trusts created in offshore jurisdictions, most foreign trusts provide the settlor with retained interests that prevent U.S. gift tax advantages. However, both U.S. citizens and resident aliens who transfer property to foreign trusts (regardless of whether they retain interests in the trust) are deemed the owner of such trust for federal income tax purposes and the income earned in the foreign trust must accordingly be reported on their U.S. individual income tax returns. Moreover, the Internal Revenue Code even provides that a nonresident alien who becomes a U.S. resident within five years after transferring property to a foreign trust must be treated as the owner of the trust property for federal income tax purposes beginning on the date on which residency began.[28]

Recent cases illustrate a willingness on the part of Untied States courts to incarcerate individuals involved in offshore trust arrangements on contempt charges. In *Federal Trade Commission (FTC) v. Affordable Media L.L.C.*, 179 F.3d 1228 (Ninth Cir. 1999), Michael and Denyse Anderson created a Cook Islands trust. The Andersons were named as co-trustees along with AsiaCiti Trust Limited ("AsiaCiti"), a company licensed to conduct trustee services in the Cook Islands. Under the terms of the trust, the Andersons and AsiaCiti were precluded from repatriating any of the trust assets to the United States when an "event of duress" occurred. The Andersons subsequently became involved in a "Ponzi" scheme and transferred their profits to the Cook Islands trust. When the Ponzi scheme was investigated, the Andersons were prosecuted, and the FTC attempted to reach the assets in the Cook Islands trust. When the Andersons were instructed to order an accounting of the trust's assets and repatriate the trust assets, AsiaCiti invoked the "event of duress" clause, removed the Andersons as co-trustees, and refused to render an accounting or repatriate the assets. The district court found that the Andersons still were in control of the trust through their status as protectors of the trust (a standard provision in a foreign trust) and placed them in contempt for refusing to render an accounting and repatriate the assets. The decision was affirmed on appeal.

In *Lawrence v. Goldberg*, 279 F.3d 1294 (11th Cir. 2002), The court found that Mr. Lawrence had control over an offshore trust, through his retained powers to remove and appoint trustees and to add and exclude beneficiaries. It then held Lawrence in contempt for failing to turn over the trust assets and ordered his incarceration pending compliance. On appeal, the "turn over" order and the contempt order were affirmed. Notwithstanding the incarceration of the individuals in both *Affordable Media L.L.C.* and *Lawrence*, their trusts repatriated no assets. However, both instances illustrate the discernment a debtor with an offshore trust will face when challenged during court proceedings.

Another negative consequence of a foreign trust may occur in bankruptcy court. In particular, if a foreign trust is created within one year of a bankruptcy filing, the bankruptcy court may deny a discharge of debts, thereby allowing creditors to pursue collection indefinitely.[29]

Other obvious disadvantages to offshore trusts

include the cost, maintenance fees, uncertainty surrounding the political situation of a particular foreign land, language and currency barriers, and conflict of law issues. Notwithstanding these disadvantages, creation of an offshore trust is perhaps the most advanced level of asset protection planning. Often the mere existence of such a trust will deter a creditor from pursuing collection of a claim. Overall, the foreign trust provides much greater asset protection than many domestic planning options mainly attributable to the expense, delay, and additional hurdles to be encountered when proceeding against assets held in such an entity.

Bankruptcy Laws and Exemption Planning

An individual facing the prospect of bankruptcy is desirous of discharging debt and shielding property to the greatest extent possible. Accordingly, an important goal of an individual's asset protection planning is to maximize the equity in assets which are "exempt" from the bankruptcy estate. Federal and state laws protect a wide variety of exemptions that are summarized below. These exemptions are crucial because often the threat of filing for bankruptcy by a debtor who owns substantial exempt assets may precipitate successful settlements without the need to file.

Exemptions. As noted above, under the Bankruptcy Code, certain property interests are exempt from the debtor's bankruptcy estate.[30] The theory behind the exemptions is that they are necessary to provide the debtor with a "fresh start" after the close of the bankruptcy proceedings. Each state is permitted to "opt out" of the federal scheme and provide its own exemptions or, a state may give its residents the ability to select between state exemptions and federal exemptions.

The question of whether it is appropriate for individuals engaging in "pre-bankruptcy" planning to exchange non exempt assets for exempt assets has been the subject of considerable litigation involving bankruptcy trustees and debtors. However, the legislative history of the Bankruptcy Code seems to anticipate this type of behavior and recognizes it is not fraudulent.[31] Notwithstanding this general recognition, a demonstration of intent to defraud a creditor when engaging in such activity will render an exemption void. Thus, the conversion of nonexempt property to exempt property must be done carefully on the advice of counsel with a thorough review of the prevailing case law that exists for the applicable jurisdiction.

Set forth below are common exemptions that are crucial to almost any asset protection plan:

Tenancy by the Entireties. As noted above, the exemption for tenancy by the entirety property varies from state to state. *(See previous discussion of tenancy by the entirety.)*

Protection of Homestead. Almost every state provides a debtor with a homestead exemption, the amount of which varies enormously from state to state. Florida and Texas have unlimited homestead exemptions whereas the federal bankruptcy homestead exemption is limited to $7500. [32] Similar to tenancy by the entirety, courts have held that a homestead exemption will not be effective against a federal tax lien.[33] If a state has a small homestead exemption, asset protection planning should focus on whether tenancy by the entirety or a transfer to a nonworking spouse (either outright or in trust) is an option. If a state has an unlimited homestead exemption, asset protection involves depleting the mortgage or making improvements on the property.

Planning for the homestead exemption may even involve establishing residency in a favorable jurisdiction (consistent with the 180-day waiting period). Moreover, a conversion of nonexempt property to exempt property with the intention of filing for bankruptcy provided that a bankruptcy court reviewing the transaction does not find the debtors actions fraudulent also may prove effective.[34]

Retirement Plans

The state and federal exemptions provided for retirement plans represent a major planning opportunity.

ERISA-qualified plans. The most important of the retirement plan exemptions is the federal exempt status granted to retirement plans that are qualified under the Employee Retirement Income Security Act (ERISA); a body of federal law governing IRS-qualified retirement plans.[35] Such plans include pension plans, defined benefit and defined contribution plans, profit-sharing plans and 401K plans. In 1992, the Supreme Court provided conclusive protection for plans governed by ERISA and further provided that the federal law protecting these plans will prevail regardless of state law.[36]

However, this protection is not absolute in all situations. The protection has been denied in at least one

situation to a plan sponsored by a closely owned business where the plan covered only the owners and their spouses. It is therefore important to include other employees in such a plan.[37] In addition, ERISA specifically provides an exception to the protective provisions in the case of qualified domestic orders obtained in connection with child support obligations, alimony payments, or marital rights. Moreover, courts have used provisions of the Internal Revenue Code to enforce attachment of a federal tax lien against plan assets.[38]

Distributions from Qualified Plans. In many states, once an individual reaches an age at which he or she is forced to receive distributions from a qualified plan, any amounts distributed lose their exempt status. However, some states extend a level of protection to distributions from retirement plans.[39] In Illinois, distributions from a retirement plan retain their exempt status to the extent necessary for support of the debtor and the debtor's spouse and dependents. Individuals residing in states that protect distributions in one form or another are often advised to hold those distributions in a segregated account apart from nonexempt assets.

Individual Retirement Accounts. By contrast, Individual Retirement Accounts (IRAs) are established under the Internal Revenue Code[40] and are not subject to ERISA. Therefore, their level of protection varies from state to state. States that provide protection for an IRA include California, Florida, Illinois, and Texas.[41]

Roth IRAs. Individuals who have established a relatively new Roth IRA should be cautioned that a state exemption protecting traditional IRAs would not necessarily extend to a Roth IRA. This is because a different Internal Revenue Code section governs Roth IRAs and many statutes providing protection for traditional IRAs refer to plans under Section 408 of the Internal Revenue Code. Thus, it is important to review the applicable statute that may or may not extend protection to a Roth IRA.[42]

Nonqualified Retirement Plans. Because a nonqualified plan is not afforded ERISA's federal protection, a review of the governing state law is necessary. States that have broad legislation that may include protection for a nonqualified plan include California, Georgia, Idaho, Indiana, and Pennsylvania.[43]

Annuity Contracts. In recent years, commercial annuity products such as variable annuities, which offer a variety of investment vehicles, have become increasingly popular for retirement planning. Exemptions for annuity contracts are available in many states and provide a valuable planning opportunity because a similar investment held outside of an annuity product (i.e., in an individual's name or jointly with a spouse), may be subject to creditor attachment. Not surprisingly, Florida exempts all annuity contract proceeds, whereas protection in Illinois and Ohio is dependent on whether the named beneficiary is the debtor's spouse or dependents.[44] The federal exemption extends only to an annuity contract to the extent reasonably necessary for the support of the debtor and the debtor's dependents.[45]

Life Insurance Policies. Exemptions for a debtor's interest in the cash value of a life insurance policy also allow an individual to accumulate investments in a product that is shielded from creditors. In some states, the protection also extends to the policy proceeds upon the death of the debtor. The federal exemption applies to all of the debtor's unmatured policies and the debtor/insured can continue to make premium payments on those polices without having the payments subject to the bankruptcy estate (under the theory that they are for the debtor's dependents and not the debtor).

The proceeds from a life insurance contract of an individual whom the debtor relied on for support are protected only to the extent found necessary for the debtor's support.[46] Like the protections for annuities, some state exemptions allow for protection of the entire cash surrender value of a life insurance policy (Florida) and some limit that protection to when a dependent or spouse is named the beneficiary (Illinois).[47] In addition, life insurance proceeds payable to a spouse or dependent are also exempt from the debtor's creditors in many states.[48]

Individuals residing in a state that does not provide absolute protection for life insurance proceeds and a policy's cash value or individuals without the requisite spouse or dependent beneficiaries should consider an irrevocable life insurance trust. If properly drafted, such a trust will shield the cash value of a policy and its proceeds from the creditors of the insured. In addition, an irrevocable life insurance trust has the added benefit of removing the policy proceeds from the insured's estate (and that of his or her spouse) for estate tax purposes, and can protect the policy proceeds from the creditors of the insured's spouse, children or other beneficiaries.

Conclusion

The importance of viewing the estate and asset protection planning process in conjunction with one another cannot be overemphasized. Common estate planning strategies (such as revocable living trusts) or seemingly benign forms of joint ownership can provide minimal protection or even have negative consequences in an asset protection context. In addition, most transfers made for asset protection reasons will have estate and gift tax consequences and therefore require an understanding of the applicable tax laws.

It also is important to keep in mind that an asset protection plan can be as simple or as complex as a given situation warrants. While offshore trusts are appropriate for a select segment of our society, the mere establishment of conventional trusts for family members or transfers to a spouse faced with less professional exposure may be all that is needed for others.

Finally, it is crucial for physicians routinely exposed to professional liability to plan in advance of a claim. Such planning should not only involve a review of individual and family assets but also consideration of techniques that can shield a potential inheritance from creditor attachment.

Endnotes

1. Most states have adopted either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act.
2. See Uniform Fraudulent Conveyance Act § 7; Uniform Fraudulent Transfer Act §4.
3. For example, under current law any individual can make unlimited gifts for tuition and medical care if payment is made directly to the educational institution or health care provider pursuant to IRC §2503(e). In addition, IRC§2503(b) allows an individual to make up to $11,000 of gifts tax-free to any individual in any calendar year. Finally, individuals are entitled to a gift or estate tax exemption amount of up to $1 million, see IRC §2010. This exemption amount is subject to increase significantly until the year 2010. See the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16.
4. See Illinois where husband and wife can only hold their principal residence in tenancy by the entirety, 765 Ill. Comp. Stat. Ann. §1005/1c (West 1998). See also Michigan where real estate (principal residence or vacation home) can be held in tenancy by the entirety Mich. Comp. Laws Ann. §557.71.
5. Fla. Stat. Ann. §689.15 (West 1998); see also *First Nat'l Bank of Leesburg v. Hector Supply Co.,* 254 So. 2d 777, 779 (Fla. 1971) (personal property); *Roger Dean Chevrolet Inc. v. Fischer*, 217 So. 2d 355, 357 (Fla. Fourth DCA 1969) (real property); *Quick v. Leatherman*, 96 So. 2d 136 (Fla. 1957) (estate by entireties available only to married persons) and *DuPont v. DuPont*, 33 Del. Ch. 271, 98 A.2d 493 (1953); In re *Shader*, 90 BR 85 (Bankr. D. Del. 1988).
6. IRC §2523(a).
7. Mich. Comp. Laws Ann §§566.31-566.34; *Dealer Supply Co. v Greene*, 108 NC App.31, 422 S.E.2d 350 rev. denied, 333 NC 343, 426 S.E.2d 704 (1993); *Premier Property Management v. Chavez,* 191 Ill. 2d 101, 728 N.E.2d 476 (2000).
8. *E.J. McKernan Co. v. Gregory,* 268 Ill. App. 3d 383, 205 Ill. Dec. 763, 643 N.E.2d 1370 (1994), appeal allowed, 161 Ill. 2d 525 (1995), appeal dismissed with prejudice, No. 78487 (May 23, 1995).
9. In re *Marriage of Del Giudice,* 287 Ill. App. 3d 215, 222 Ill. Dec. 640, 678 N.E.2d 47 (1997).
10. 735 Ill. Comp. Stat. Ann. §5/12-112 (West 1998).
11. See also Premier Property 728 N.E. 2d 476.
12. *US v. Craft,* 535 U.S. 274; 122 S. Ct. 1414; 152 L. Ed. 2d 437 (2002).
13. Restatement (Second) of Trusts §156.
14. Restatement (Second) of Trusts §155.
15. Restatement (Second) of Trusts §152(2).
16. IRC §2056(b)(7); Treas. Reg. §20.2056(b)-7.
17. A Qualified Domestic Trust or "QDOT" trust pursuant to IRC Sections 2056(d) and 2056A.
18. Rosen and Rothchild, 810 — *2nd T.M. Asset Protection Planning.*
19. IRC §2518(a) provides the requirements for a "qualified" disclaimer.
20. See Fla. Stat. Ann. §732.801(6); Mass. Gen. Laws Ann. Ch. 191A§8; Wash. Rev. Code Ann. §11.86.051.
21. Alaska: Alaska Stat. §34.40.110 (2001); Delaware: 12 Del. Code Ann. tit. 12 §3570 et seq. (1997); Missouri: Mo. Ann. Stat. §428.005-428.059, 456.020, 456.080 (West 1998); Nevada: Nev. Rev. Stat. ch. 166 (2001); Rhode Island: R.I. Gen. Laws §18-9.2.1 et seq. (2001).
22. Alaska Stat. §34.40.110.
23. 12 Del. Code Ann. §3570 et seq.
24. IRC §2036(a)(1).
25. U.S. Const., Art. IV, §1.
26. See for example, §13C of the International Trusts Act 1984.
27. See §18B of the International Trusts Act 1984 (Cook Islands); §24 of the Nevis International Exempt Trust Ordinance, 1994.
28 IRC §679.
29 Spero, *supra* §7.01[5].
30. 11 U.S.C. §522.
31. HR Rep. No. 595, 95th Congr., 1st Sess. 361 (1977); S. Rep. No. 989 95th Congr., 2d Sess. 76(1978); Rosen and Rothchild *supra* at 43.

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32. Fla. Const. art. X, §4; Fla. Stat. Ann. §222.05 (West 1998); Tex. Prop. Code Ann. §41.001 (West 1998); 11U.S.C. §522(d)(1).
33. *Weitzner v. U.S.,* 309 F.2d 45 (Fifth Cir. 1962).
34. In re *Levine,* 40 B.R. 76 (Bankr. S.D. Fla.1984).
35. 29 U.S.C. §1001.
36. *Patterson v. Schumate,* 504 US 753 (1992).
37. See, for example, In re *Witwer*, 148 BR 930, 938 (Bankr.CD Cal. 1992).
38. *U.S. v. Sawaf,* 74 F3d 119 (Sixth Cir. 1996).
39 See, for example, KRS 342.180; 40 Ill. Comp. Stat. Ann. §5/12-1006(b)(3).
40. IRC §408.
41. Cal. Civ. Proc. Code §704.115(e) (West 1998); Fla. Stat. Ann.§222.21(2)(a) (West 1998); 40 Ill. Comp. Stat. Ann. §5/12-1006(b)(3) (West 1998); Tex. Gov't Code Ann. §811.005 (West 1998).
42. Roth IRAs are governed by IRC §408A.
43. Cal. Civ. Proc. Code §704.115(e) (West 1998); Ga. Code Ann. §§44-13-100(a)(2.1)(c), 18-4-22 (1997); Idaho Code §55.1011 (1997); In. Code Ann. §34-55-10-2(b)(6) (West 1998); 42 Pa. Cons. Stat. Ann. §8124(b)(a)(ix) (West 1998).
44. Fla. Stat. Ann. §222.14; Ohio Rev. Code Ann. §3911; 735 Ill. Comp. Stat. Ann. §5/19-117 (West 1998).
45. 11 U.S.C. §522(d)(10)(E).
46. 11 U.S.C. §§422(d)(7) and (d)(11).
47 Fla. Stat. Ann. §222.14 (West 1998); 215 Ill Comp. Ann. §5/238 (West 1998).
48 S.C. Code Ann. § 38-63-40(A); Haw. Rev. Stat. §431:10-232(a); 735 Ill. Comp. Stat. Ann. §5/12-1001(f) (West 1998).

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21. An offshore or foreign trust typically is established to achieve:
A. discharge of an individual's debts if he or she files for bankruptcy.
B. asset protection for a self-settled trust.
C. relief of the trust assets from U.S. income and estate tax liability.

22. Both qualified retirement plans and IRAs are ideal opportunities for asset protection because of the exempt status they enjoy under federal law.
A. True
B. False

23. Based on the facts presented, which of the following actions, on their own, are likely be considered a fraudulent transfer when reviewed by a court?
A. A transfer of an investment account to a spouse with the intent to shield the account from the attack of future creditors
B. A transfer to an educational trust for a child that renders the transferor insolvent
C. Establishing residency in Florida and shortly thereafter converting nonexempt property to exempt before filing for bankruptcy
D. A transfer to an offshore trust with the retained ability to receive income and principal from the trust

24. Asset protection for physicians is typically accomplished through the structure of a medical practice or professional service corporation.
A. True
B. False

In Future Issues: **Abdominal Pain**

Insert. Traditional Asset Protection Planning Concepts for Business/Corporate Entities

It is crucial for physicians and other health care professionals to seek professional advice in the establishment of a private practice or professional service corporation; a discussion of the various business structures and related business issues for physicians is beyond the scope of this article. It is important to note that despite the various available entities offering creditor protection, state statutes and judicial decisions consistently provide that professionals such as physicians, dentists, and attorneys face personal liability in connection with legal actions brought against them for malpractice.[1]

Of course, a medical practice such as a professional corporation and its individual professionals will carry malpractice insurance as protection for such situations. Nevertheless, there always is the possibility that: 1) a judgment may be rendered that exceeds the malpractice insurance coverage limits on a given policy; 2) the insurance carrier may disallow coverage of a claim; or 3) the insurance carrier becomes insolvent. Thus, it is crucial for physicians and other professionals to explore asset protection strategies to insulate their personal holdings from their professional liabilities. Accordingly, the following discussion concerning limited liability achieved through business entities does not pertain to claims based upon professional liability:

Corporations. A longtime estate planning and asset protection technique involves the use of a corporation in an attempt to limit liability for it owners (the shareholders). In general, a corporation is treated as a separate legal entity distinct from its owners, and, absent special circumstances, the owners' personal holdings are not subject to exposure for the debts incurred by the corporation. As a general rule, the shareholder's liability for corporate debts is limited to the amount of the shareholder's investment in the corporation.

Nevertheless, there are several circumstances under which a corporation's shareholders are subject to personal liability. Shareholders personally are liable if they personally guarantee a corporate obligation and if it can be demonstrated that they are conducting business in their individual (rather than corporate) capacities.

"Piercing the corporate veil" refers to a judicial willingness to ignore the corporate structure and hold a shareholder's personal assets accountable for the corporate liabilities. Examples of where creditors generally are successful in piercing the corporate veil involve situations in which egregious conduct on the part of the shareholder would produce a great inequity for a creditor. In addition, limited liability will be set aside if it can be established that the shareholders did not recognize the corporation as a distinct entity by maintaining minutes of corporate meetings, mandatory state recordings and annual filings were ignored; or that the shareholders commingled corporate assets with their individual assets.

Limited Partnerships. Limited partnerships are a longstanding asset protection planning technique and have been employed by practitioners for their asset protection and tax advantages. In recent years, plans including limited partnerships have become slightly less popular due to the advent of limited liability companies *(see p. 2)*. Like a shareholder in a corporation, a limited partner's exposure for the debts of a partnership is limited to the amount of the limited partner's investment in the entity. Thus, a creditor of a partnership attempting to satisfy a debt of a partnership cannot execute upon the personal assets of a limited partner in an effort to satisfy the obligation. The general partner, however, is liable for the partnership debts while maintaining control of the entity. Thus, plans involving a limited partnership often use a corporation or other entity as a general partner.[2] In addition, many strategies contemplate a general partner giving the majority of the value in the partnership to the limited partners while retaining control.

Additionally, a limited partnership has an added advantage in that state law limits the remedies available to a creditor of a limited partner. Specifically, a charging order is the exclusive remedy of creditors of the limited and general partners of a limited partnership. This means that if a creditor is successful in securing a judgment against a limited partner, that partner can merely "assign" the partnership interest to the creditor. As an assignee, the creditor does not obtain the rights of a partner but only obtains the ability to receive distributions (if any) that the debtor would have received. In the context of a

properly drafted family partnership agreement with "friendly" partners, a judgment creditor's ability to satisfy a debt through receipt of the debtor's partnership distributions can be prevented.

Limited partnerships or family limited partnerships have long been touted for their distinct estate and gift tax planning advantages. The IRS has consistently permitted individuals to obtain steep discounts in valuing gifts of limited partnership interests to family members. This is because the governing limited partnership agreement often restricts the rights of the limited partners, thereby allowing minority interest and lack of marketability discounts to substantially reduce the value of the underlying partnership interests that are transferred.

Limited Liability Companies. A limited liability company (LLC) is a statutory entity governed according to the applicable state LLC statute. An LLC's owners are referred to as members and an operating agreement is the primary instrument governing an LLC. LLCs have both of the asset protection advantages afforded to a limited partnership (limited liability and charging order remedies for a creditor of a member). However, LLCs have an added advantage in that its members actively can participate in the management of the company without risk of exposing the member's limited liability (in contrast to a limited partnership where only a general partner maintains the ability to manage the entity).

LLCs provide the similar estate and gift tax-planning opportunities available through limited partnerships.

Endnotes

1. Spero P. *Asset Protection Legal Planning and Strategies,* § 9.05. *See also* statutes relating to professional service corporations such as 805 Ill. Comp. Stat. Ann. (West 1998); Fla. Stat. Ann. §621.07 (West 1998); NY Bus. Corp. Law §§1501-1516 (McKinney 1986, Supp. 1991).
2. Such techniques involving "layering" entities such as partnerships, corporations, and LLCs frequently are implemented in sophisticated asset protection plans to add an additional layer of protection to the arrangement.