ASSET PROTECTION IN ESTATE PLANNING

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Definition of Asset Protection Planning:

- Consideration and implementation of advance planning techniques designed to place assets outside the reach of potential future creditors (not hiding assets, committing fraud or fraudulent transfers)
- Essentially, there are two kinds of asset protection:
- Reactive – After an event that enhances liability has occurred
- Advance - Prior to such an event (or at least knowledge of such an event)

This presentation will focus solely on advance planning which is the underpinning of estate planning. For this purpose, advance planning means planning in advance of, e.g.:

- Acquiring an asset
- Entering into a business transaction
- Entering into a contractual relationship – including marriage
- Making a donative transfer whether by gift or bequest

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WHAT IS ADVANCE ASSET PROTECTION PLANNING?

Planning to protect assets from the claims of future creditors.

- Contractual liability
- Negligence/strict liability
- Fiduciary liability

Not necessarily planning to avoid taxes, but can have an impact on tax planning

WHY ASSET PROTECTION?

- Continuing innovation on theories of liability (e.g., single business enterprise)
- Punitive damages
- New regulations create new causes of action
- Open limitation periods
- Litigious society

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WHEN SHOULD ASSET PROTECTION BE EMPLOYED?

- Not to defraud creditors
  - Often too late if claim has ripened
  - Fraudulent transfer laws (LA laws of Revocatory Action and Oblique Action)
  - Bankruptcy preferences
  - Liability of advisors
  - Ethical considerations
- Plan for asset protection before the liability arises
- Be properly insured

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PROTECTED ASSETS (ASSETS THAT ARE EXEMPT FROM SEIZURE BY CREDITORS OR EXEMPT IN BANKRUPTCY)

- State/Federal law
  - Most states
    - Life insurance; LA limitation – over $35,000 within 9 months
    - Annuities - (i) LA limitation –within 12 months, excludes alimony and child support
    - IRAs/Qualified Plans
    - Limited Wage and Homestead
- Some states
  - Unlimited Homestead (notably Florida and Texas)
- Issue of domicile
- Foreign law
  - Foreign situs assets
  - Foreign annuities
    - Not subject to foreign trust laws
    - Typically managed by foreign hedge funds
    - Typically minimum $5,000,000 purchase
    - Could exchange under IRC §1035 for U.S. annuity
    - Tax-free buildup under U.S. laws
    - Foreign laws can protect
    - Risk of foreign situs
    - excise tax of 1% on funding (except for treaties – e.g. Swiss)

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OWNERSHIP OF ASSETS FOR MAXIMUM ASSET PROTECTION

- Between spouses
  - Low risk spouse should own
    - Estate planning issues
    - Risk of divorce
    - Income tax issues
  - Tenancy by the entireties (for non-Louisiana assets)
    - Cannot be seized for debts of one spouse because belongs to both
    - Success if the surviving spouse is the nondebtor
  - Marriage contracts
    - Community property (all subject to community debts)
    - Separate property
  - Ownership in indivision

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OWNERSHIP OF ASSETS FOR MAXIMUM ASSET PROTECTION (cont'd)

- Use of limited liability entities
  - Do not engage in activity outside of one (corporation, limited partnership, limited liability company)
  - Divide activities into separate entities
  - Assets placed in entity can have a discounted value
    - For estate planning purposes
    - In the hands of creditors
    - Typical factors for discounts
      - Lack of control
      - No rights to liquidation
      - No rights to income
      - Flow through of tax without distributions
  - Best form of entity – LLC?
    - Charging order
    - Transferee status

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OWNERSHIP OF ASSETS FOR MAXIMUM ASSET PROTECTION (cont'd)

- Desirable provisions in entity organizational documents
  - Control provisions
    - Corporations – voting trusts/non-voting stock/supermajority provisions
    - LLCs – management succession, transferee rights only, non voting interests
  - Transfer restrictions
    - Shareholders' agreement or operating agreement provisions on bankruptcy/seizure/divorce buyout
- Foreign Entities
  - Foreign Laws govern seizure and devolution
    - Foreign reporting issues
    - US agent requirement
    - Foreign disregarded entity
    - Need for foreign probate

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OWNERSHIP OF ASSETS FOR MAXIMUM ASSET PROTECTION (cont'd)

- Use of debt
  - Encumber unprotected assets
    - Portfolio securities
    - Real estate
  - Protect the money
    - Annuity
    - Insurance Wrappers
    - Trust
  - Use of line of credit for future draw down on pre-mortgaged assets
- Retirement Plans and IRAs
  - E-IRAs (Coverdale)
  - Roth IRA's
  - 529 plans
  - Consult state law for limitations on exemption
- Gifts
  - Transfer of assets to low risk family members -- use of current $5,000,000 gift tax exemption
- Insurance and annuities

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DISCLAIMERS

- Provide contingent direction of property upon death (in both wills and beneficiary designations) so that primary beneficiaries can disclaim to avoid attraction of assets for benefit of creditors
- Generation skipping tax concerns
- Use of trust with spendthrift provisions

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DOMESTIC TRUSTS

- Spendthrift provision
  - Protects all beneficiaries except settlor
  - Common exceptions
    - Rights of children and spousal rights
    - Abusive situations
    - Certain government claims
- Generation skipping/dynasty trusts to keep assets protected on a multi-generational level
- Domestic asset protection trusts
  - No or liberal rule against perpetuities
  - Minimal contacts with state required
    - Need one local trustee or some assets administered in state
  - Permits settlor to be discretionary beneficiary
  - Settlor's creditors cannot compel distributions to settlor
  - Tax effects
    - May be completed gift so may not be in settlor's estate
    - Gift tax consequences if completed gift
    - Income tax bracket compression
    - Use in intentionally defective grantor trust plan

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DOMESTIC TRUSTS (cont'd)

- Not fully tested – full faith and credit issues
- Subject to U.S. Bankruptcy laws
- Probably will not hold up in abusive situations
- 13 states with some form now – NV, AK, SD and DE rated best
- No state income tax
- Common protective Trust Provisions
  - Discretionary Distributions
  - Spendthrift Provisions
  - Duress Provisions
  - Flight Clauses
  - Trust Protector
- Confidential trusts

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OFFSHORE TRUSTS

- For U.S. and non-U.S. assets
- Usually a U.S. entity (LLC) holds the ownership interests in the U.S. assets, all the ownership interests in which are owned by the foreign trust
- Usually for a fixed term
- Usually provides for discretionary only distributions
- Trustees
  - At least one in the local jurisdiction
  - Multiple trustees possible
- Protectors
  - Can remove/appoint trustees
- Flight clauses

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OFFSHORE TRUSTS (cont'd)

- Offshore Laws Protect
  - U.S. judgments not enforceable
  - Must retain local counsel (most of whom are conflicted)
  - Must retry the case
  - No contingency fee arrangements
  - Loser pays legal fees
  - Will not protect in abusive situations
  - Creditors can get pre-trial relief from flight of funds

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OFFSHORE TRUSTS (cont'd)

- Effect of U.S. bankruptcy laws
  - Have forced banks with branches in U.S. to divulge information or give up funds
  - Have refused to discharge creditors
  - Have held creditors in contempt
- Effect of new U.S. tax law changes
  - Reporting requirements
    - Classification as Foreign
    - Information reporting
    - Foreign Account reporting
  - Expatriation tax
    - Section 684 sale or exchange (unless grantor trust)
  - IRS enforcement efforts
    - High Profile?
- High risk in income tax planning

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CONCLUSION

- What should estate planning professionals do?
  - Advise clients to consider asset protection in the context of their planning, not just for themselves, but for their family
  - Work with each other to design a complete plan that takes into account all aspects legal, tax, insurance, protection of assets
  - Opportunities with (perhaps temporary) expansion of exemptions
    - Gift of LLC interests to GST IDGT in protection state
    - Highly leverage insurance in trust
    - Gift of foreign annuity

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