An essential guide for professionals and their clients

ASSET PROTECTION

...in financially unsafe times

Arnold S. Goldstein, Ph.D. & W. Ryan Fowler

Forward by Hillel L. Presser, Esq.

President, National Association of Asset Protection Attorneys

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...

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FORWARD

As president of the National Association of Asset Protection Attorneys (NAAPA), I am delighted to write the forward for this important new book.

Asset Protection…in financially unsafe times, by my colleagues Arnold S. Goldstein and W. Ryan Fowler, is a welcome and much needed addition to the fast-growing specialty of asset protection. Increasingly, individuals, families and even corporations are recognizing the need to defensively position their assets to withstand attack against the many legal and financial threats that are so prevalent in today's society: lawsuits, creditor problems, foreclosures, divorce and even tax troubles.

I have known Arnold for several years and he has been my mentor in helping me achieve my own position of prominence within the specialty. He is also my partner in Presser Goldstein. His knowledge of the field is unsurpassed.

Ryan is one of America's best asset protection strategists, innovators, researcher and practitioner. I have worked closely with Ryan on a number of cases, and his knowledge has been invaluable.

For these reasons, I am deeply honored to express my feelings on the unique contribution that both Arnold and Ryan have made through their authorship of this book. Through their skill they have successfully created what is perhaps the most up-to-date book on the subject, presented in a way that will prove invaluable both to the professional advisor as well as their clients.

Hillel L. Presser, Esq.
Boca Raton, FL.

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INTRODUCTION

Protecting yourself against the unexpected is a vital element in financial planning. This means having adequate protection against all forms of financial exigencies that can erode — if not completely eliminate your wealth.

We wrote this book because there is a need for more legal and financial professionals to advise their clients on the many ways they may go about protecting their wealth in these financially perilous times.

The mention of wealth protection can take on many dimensions. It certainly includes economic hazards — such as market downturns, inflation or confiscatory taxes. And those are serious concerns. Fortunately, most financial advisors focus on these concerns and prepare their clients for these possibilities quite competently.

We discuss these same concerns within this book — but our writing has a somewhat different focus. We address the more commonly overlooked planning issues – strategies one can take, indeed, must take — to protect their wealth against such predatory threats as lawsuits, creditors, tax claims, bankruptcy and the many other life challenges for which so few of us are well-prepared.

Who can benefit from this book?

Our objective in writing this book is to present asset protection strategies at a level that would be comprehensible, useful and hopefully even interesting to the professional and their clients. The term professional in this context does not mean attorneys exclusively, though attorneys who are unfamiliar with asset protection practices will certainly find much information here that can increase their knowledge of the subject. Financial planners, accountants and insurance professionals also have clients who can benefit from their advisors bringing to the planning process an appreciation and understanding of the need for asset protection — as well as solutions. This book will certainly help the non-attorney professional work more collaboratively with asset protection attorneys in creating comprehensive, integrated plans appropriate for their clients needs.

More than a professional treatise, this book is written at a sufficiently basic level to be helpful to the client — the layman who has little or no familiarity with asset protection. It will help those:

- from every economic background
- who are now unprotected against lawsuits or have a plan in place and seek ways to improve their protection
- who need to protect their own wealth or their clients wealth
- who need to shelter not only their personal assets but also their business or professional practice
- who are starting out in life and want to secure their future wealth or are in their twilight years and want to safeguard their nest egg or children's inheritance
- who want to integrate wealth protection with their investment, tax and estate planning objectives

How to Use this Book

These pages explain the same proven, practical strategies that anyone can use to protect their wealth. These are the same tactics and tools that we, as asset protection specialists, have used to successfully shield the wealth of thousands of individuals, families and companies nationwide.

Nevertheless, this book is not intended to promote 'do-it-yourself' planning. Asset protection is a highly complex legal specialty and every plan must be customized to the needs of the client after considering a broad range of issues. Many strategies in this book may not be suitable in a particular set of circumstances and may carry unfavorable tax, estate planning or other legal or financial consequences. Therefore, the reader is advised to take no action without consulting a qualified asset protection advisor. Moreover, laws change and vary between states, and any statement made in this book can only be taken as a general proposition and subject to exceptions. Accordingly, the authors and publisher disclaim any liability for any action taken or not taken in reliance on the information in this book.

We do hope the reader will find this to be a valuable reference and armchair advisor on how to protect the wealth they have worked so hard to build!

CHAPTER ONE

Liability Threats and Why You Need Asset Protection

As most of us know, the U.S. is a lawsuit-crazy country. It's an exaggeration to say most businesses and wealthy individuals are sued several times a year, although this certainly happens in some cases. However, if you only get sued once, and as a result you lose your home, your car, bank accounts, brokerage accounts, *everything*, wouldn't you have wished you'd done some planning to keep those assets safe?

Threats to your wealth don't just come from lawsuits. There's also divorce, bankruptcy, federal or state tax problems, and non-judicial government seizures. There are also estate tax and market downturn threats, which we discuss later in this book. Although this chapter primarily focuses on liability threats, we should always remember that estate taxes and market downturns can be just as great or greater a threat to one's wealth. In the authors' opinion, no wealth preservation plan is complete until it accounts for *all* threats, not just liability and creditor threats. This book therefore discusses estate tax matters in Chapters 9, 11, 13 and 14, and economic threats in Chapter 16.

Considering the U.S. divorce rate alone is over 50%, when you add everything together, it is *probable*, not just possible, that at some point in your life your accumulated wealth will be in serious jeopardy.

Although threats to your wealth come from many areas, fear of lawsuits is what drives most people to seek asset protection. Lawsuits come about because a plaintiff claims another person, the defendant, is liable for damages or some type of debt. The means by which such liability attaches to a person, which could lead to litigation or other creditor attack, are many and varied. This chapter attempts to examine the many types of liability-related risks, and why asset protection is an essential counter to these risks.

Direct Civil Liability

Damaging another party may lead to litigation resulting in a settlement or judgment against you. This type of tort (a tort being the wrongful act that leads to litigation) causes *direct civil liability* or *simply direct liability*. Direct liability is in line with common sense: if you caused damage, you or your insurance should, of course, compensate the damaged party.

Frivolous Lawsuits and Excessive Judgment Awards

Unfortunately, even in direct liability cases, there are frivolous lawsuits or a party seeks outlandish awards for minimal or insignificant damages. A particularly illustrative case involved judge Roy Pearson who sued his dry-cleaner for $65 million because they lost his pants! Fortunately, although frivolous lawsuits and extraordinarily high judgment awards make headlines, most frivolous lawsuits are dismissed, making such cases the exception and not the rule. Therefore, although a serious concern, these lawsuits are not as common a threat to one's wealth as those arising from indirect liability.

Indirect Civil Liability

Indirect civil liability (often simply called *indirect liability*) is liability that attaches to someone other than the person who committed the tort. Indirect civil liability is the greater threat to wealthy individuals, because it allows plaintiffs to attach liability to almost anyone with vulnerable wealth (the "deep pocket") rather than the person who actually committed the offense.

Indirect civil liability, excessive judgment awards, and the following factors have turned our legal system from one of justice to one of redistributing wealth from the haves to the have-nots:

- Most civil plaintiff's attorneys are paid a percentage of amounts collected from litigation[1], so the larger the judgment or settlement, the more money they make. This in turn means attorneys try to sue as many people as possible in any given case. This is the reason for various theories of indirect liability.

- Judges support theories of indirect liability which attach to the person with the most money rather than (or in addition to) the person who committed the offense.

- Juries decide on emotions. A 'Robin Hood Mentality' rather than sound legal reasoning are unpredictable at best and catastrophic to a defendant's wealth at worst. Case in point: a large lawsuit against a Giants Stadium concession company resulted in a $110 million judgment, and the New Jersey Supreme Court ordered a retrial because of several legal errors by the superior court's presiding judge which led to such a high verdict. The injured party in this lawsuit was a 2 year-old girl who was struck by a drunk driver that bought alcohol from the concession company. No one will say the permanent paralyzation of an infant is not a great tragedy, however there is a strong trend in litigation that links emotionally charged cases to unusually high judgments. Why was the drunk driver not sued? Why was the concession company's employee who sold the alcohol to the drunk driver not sued? Why only the deep pocket defendant? How many people lost their jobs because the deep pocket had to pay $110 million to the plaintiff, which forced them to lay off employees as a result?

One only has to randomly read a few civil cases to see how thoroughly established indirect liability has become in our legal system. Study enough of these cases and you see many examples of indirect liability:

- An employee causes damages so the employer is liable for their employee's actions.

- A vehicle is involved in an accident; the owner is liable even if s/he wasn't driving it.
- A landlord fails to maintain property (for example they don't put salt on an icy sidewalk) and someone is injured; the non-managing property owner may be liable.
- An individual buys a property for someone else. The recipient then intentionally or unintentionally uses that property to injure themselves or another (e.g. you give a hunting buddy a gun and then he shoots himself or someone else); the gift-giver is liable under the "theory of negligent entrustment". Yes, people have actually been sued for giving gifts!
- A person refers someone to a business or service that ends up committing a tort; the referrer can be sued as a result. Litigation from this type of liability is common, especially among professionals such as CPAs, financial advisors, and attorneys who refer clients.

These are only examples of indirect liability. Indirect liability can be further broken down into subsets, such as *lingering liability*, which we'll now discuss.

Lingering Liability

Lingering liability is liability that may be triggered many years after the tort or negligent act was committed. To explain lingering liability, let's examine a Texas case from several years back. A homebuilder built a home to sell it. He subcontracted another company to put in a septic system. Instead of installing a proper septic system the subcontractor cut corners to save money and used a large propane tank. Ten years later, the propane tank leaked, raw sewage seeped through the home's foundation and into the walls. Everyone living in the home (including an 8 month old baby) developed staph infections, which required hospitalization. The original builder had operated as a sole proprietorship when the home was built, was sued for a very large sum of money and lost, despite the fact that another company put in the faulty septic tank.

In this situation, we must ask ourselves:

- If at some point in the 10 year period between when the home was built and the septic tank leaked, I had sold or re-sold the home, could I be named as a party on this lawsuit?
- Shouldn't a real estate property inspector have been able to determine an incorrect septic tank was installed? (Hint: When's the last time you've seen a real estate inspector dig up a yard to look at a septic tank?)

The answer to the first question is yes, you could be sued if you sold a property with major defects, even if you didn't know about the defect, and even if a qualified professional inspected the property. Remember: in court, the facts are not decided by real estate inspection experts. They are decided by a jury, who may not have the faintest idea about real estate. The jury will most likely think, however, that someone who owns rental units or buys and sells real estate is *rich*. They're *angry* that an 8 month old baby was hospitalized. Whether or not you could have detected and corrected the problem is besides the point.

Would this jury play "Robin Hood"? Would they take from the so-called haves (you) and give to the have-nots, regardless of fault? In a country where over 30 million lawsuits are filed each year, it happens many times each day.

Expanded Liability

A similar situation happened to one of our clients long before he'd seen the need for asset protection. His case falls not only under lingering liability, but also under something we call *expanded liability*, another type of indirect liability.

Many years ago he operated a car dealership as a sole proprietorship. He bought a used car with damaged brakes, sent the car to a mechanic's shop for repairs, and then sold the car. *Ten years later*, the car was involved in an accident which unfortunately resulted in multiple fatalities. The car brakes had failed. Even though the brakes had worked perfectly for ten years, guess who got sued? That's right, the person who had operated his dealership as a sole proprietorship. Fortunately he only lost $50,000 in this case, but it could have turned out far worse.

Notice that his company wasn't even the one that fixed the brakes, yet it was the one that got sued? This is a perfect example of expanded liability. People are sued under theories of expanded liability because attorneys collect a percentage of the judgment or settlement award amount when they sue so they have an incentive to sue as many people as possible, for as much as possible. More people sued equals more money, which means the attorney gets more fees.

Using Theories of Expanded Liability to Go After Deep Pockets

Another highly public case more clearly illustrates how theories of expanded liability are used to go after deep pockets. Earlier we discussed a Giants stadium concessionaire whose employee sold beer to an already inebriated man during a game. After the game the intoxicated man was involved in an accident resulting in a fatality. The drunk driver was broke and even though he went to jail, the plaintiff's attorney didn't pursue anything beyond his insurance company's $200,000 payout. Nor did the employee who sold the beer pay a dime to the defendant, despite his poor judgment. The employee's large and wealthy employer, however, lost the lawsuit and was ordered to pay *$110 million dollars* to the plaintiff.[2]

Who had the money? Who got stung? If you are only remotely connected to a lawsuit and no one else involved has significant assets but you, who do you think the plaintiff's attorney will pursue?

How Bad Is The Problem?

Almost anyone would agree that our legal system is out of control, but *how* bad is the problem? Consider the following:

- The U.S. tort system is the most expensive in the industrial world. U.S. tort costs are 2.2 percent of the gross domestic product – 244 percent that of other advanced industrialized countries.[3]
- Dynamic and static costs of litigation in the U.S. are an estimated *$865.37 billion dollars each year*![4]
- When compared to average tort costs in other developed countries, the annual excess litigation costs in the U.S. are a staggering *$589 billion per year!*[5] This amounts to an average "tort tax" on an American family of four of $9,827 each year.[6]

- There are over one million lawyers in America.[7]
- In 2006, the IRS performed 3,742,276 levies.[8]

These few statistics lead us to deduce the obvious: our current civil litigation system is a monumental drag on our economy and an extreme burden born on each and every American. It drastically increases the cost of services, goods, and health care, and forces thousands of Americans out of jobs each year when the companies they work for are forced into bankruptcy or massively downsized due to adverse litigation.

Who Needs Asset Protection?

Some would say that only the rich are the targets of litigation. Although many people feel their wealth is safe, or not enough for someone to go after via our legal system, this attitude is naïve. Invariably people with this attitude have bought into one or more of the following myths:

Myth #1: "I Can't Get Sued. I'm Too Careful."

While you need not do anything incorrectly to find yourself on the wrong end of a lawsuit, there are those who believe that because they've never been sued before, their chances of being sued in the future are very slim.

For example, one of our clients once claimed they'd never be sued because they were merely a schoolteacher. It's true that this person will probably never be sued for teaching, yet this person *was* eventually sued for over a million dollars for negligently handling her mother's estate.

Obviously, a lawsuit need not relate to your employment. You may be cautious and careful and still get sued. Since anyone who drives could get in an accident, which could lead to a large lawsuit well in excess of insurance costs, we all have some risk of being sued at some point in our lives. It is not only doctors, real estate developers, or business owners who incur liability or attract lawsuits; everyone is a potential target.

Professionals, of course, have a higher-risk of being sued than your "average Joe". When a surgery fails, a trial is lost, or an investment sours, the patient, client, or investor concludes that the professional is to blame. Unfavorable outcomes translate into 'sue the professional.' These plaintiffs 'walk the Yellow Pages' for a lawyer ready and willing to take the case. Others are also high on the lawsuit hit list: parents of teenage drivers; commercial real estate owners; small business owners; accountants and other business advisors; architects and engineers; corporate officers and directors; directors of charitable organizations; police officers; celebrities; sports figures, and the conspicuously wealthy.

It's not what you do, but how much you own that determines your vulnerability.

Even the proverbial little old lady in tennis shoes can get into big legal trouble. For instance, on one occasion an 83-year-old great grandmother accidentally hit the gas rather than the brake and slammed her Lexus through a K-Mart storefront, seriously injuring several shoppers. She was subsequently sued for considerably more than her insurance coverage. This was her first lawsuit in eighty-three years, but she'll be the first to admit the prospect of losing one's life savings, even at 83, is extremely unpleasant.

Myth #2: "I don't need asset protection. I don't have enough assets to protect."

How would you feel if you lost what few assets you do own? Wealth is relative. It is not only the rich and affluent who need asset protection; if you have *any* assets, they need protection.

An example to illustrate this point involves an airport shoe-shiner. He was sued for $100,000 on a bank loan he guaranteed for his son. He owned only his Bronx home with $100,000 equity. To some people, $100,000 is hardly serious wealth. While they would hate to lose it, such a loss would not hurt their lifestyle. That $100,000 was this man's entire lifetime accumulation. How many more shoes must he shine to replace his $100,000 nest egg?

Another example is that of a married couple who were small business owners. They were of modest wealth, but nonetheless they decided to be pro-active and do asset protection. A while later they ran into IRS trouble, and subsequently the IRS tried to levy $8,000 from their business account. If the IRS had been successful, the business would have been seriously interrupted. The levy would have cut off their only source of income and crippled their ability to pay other creditors, which could have caused the business to fail. Fortunately, because the business was an

LLC, the IRS was unable to seize the money for the couple's personal tax problems. Asset protection allowed the business to run uninterrupted while the tax debt was resolved in a fair and equitable manner. Although in the narrowest sense this planning may have only saved them $8,000, to this married couple the planning's value was much, much greater. They were very glad to have paid less than $3,000 to do some simple planning in a timely manner.

We receive calls from people throughout the country who have creditors or lawsuit problems. Many have only a few dollars in the bank, a small house, or perhaps some modest investments. Whatever their wealth, it is precious to them. Protecting their assets is as serious a matter as protecting someone else's millions. Wealth is relative, and you must treat your wealth accordingly. You must protect *any* asset that is important to *you*.

Myth #3: "I Don't Need Protection. I'm Insured."

This is another fallacy. You buy a liability policy and figure, "That's it, I'm covered. If I'm sued, my insurance will take care of it."

Although liability insurance is an excellent (and recommended) first line of defense against lawsuits, it has its limits: you could be sued for more than your coverage amount, or your policy may not cover you in situations where you thought it would. In fact, liability insurance covers only about one in three lawsuits. Furthermore, no insurance will protect against divorce, bankruptcy, or tax problems, although asset protection will if done in a correct and timely fashion. Even worse, a very large liability insurance policy may actually make one an attractive target for litigation.

A moderate amount of liability insurance is thus recommended, especially when you consider that no asset protection plan will pay for a defense attorney when you're sued, although a liability policy generally will (at the same time, this attorney may be looking out more for the insurance company's interests than your own, which is why it's often a good idea for you to hire an attorney to watch over the attorney the insurance company provides you.) Furthermore, a moderate insurance policy is a good way to divert a creditor from your hard-to-reach, asset-protected wealth to an easy insurance payout. This tactic is more fully discussed in Chapter 4, The Benefits and Psychology of Asset Protection.

A textbook example of the inadequacy of insurance alone comes from a physician named John[9]. John argued for years that he did not need any more lawsuit protection than his five million dollar malpractice policy.

However, you can bet he wished that he had protected his assets after an employee sued him for two million dollars on a sexual harassment claim. His malpractice insurance was also useless to shelter his wealth when Uncle Sam demanded he repay millions that he allegedly over-billed Medicaid. Even when a claim is insured, you must ask whether the insurance will fully cover the claim. A million-dollar liability policy does not mean much when you are sued for two million. With today's unpredictable, ludicrous jury awards, you cannot foresee what damages you may someday be forced to pay. Then, too, you may discover that liability insurance is not your complete answer to financial security.

There are countless policy exclusions, the inevitable loopholes that let your insurance company deny coverage. Nor will your insurance company always defend a claim that is supposedly insured. The many 'bad faith' claims now pending against insurance companies prove this point.[10]

You cannot even be sure that your insurance company will be in business when you need them. For example, some of our past clients include scores of physicians in Ohio, New Jersey, and several other states whose insurance companies filed bankruptcy. These doctors thought they were protected, but they are now exposed with little or no coverage. Many are in the middle of lawsuits!

Buy whatever liability insurance you can reasonably afford, but look upon insurance as a starting point. Liability insurance cannot take the place of a good asset protection plan, which you need to protect yourself from any type or size claim.

Myth #4: "Asset Protection Is Too Costly. I Can't Afford It."

Protecting your assets is not too costly, and probably will not take more than a few hours of your time. I find the average family can gain strong protection for their assets for a few thousand dollars, sometimes even less. We have sheltered larger fortunes (in the millions) often for around $6,000-20,000, and there are many protective steps that cost absolutely nothing.

A doctor who was a prospective client once complained he did not have the spare cash to set up the few entities he needed to safeguard his $3 million net worth and considered the $15,000 asset protection fee too great a cost. However, he spends $65,000 a year for malpractice insurance. This same $65,000 policy only covers malpractice claims, and only for one million dollars. Next year the good doctor will pay another $65,000 (assuming his premiums do not increase) for the same limited protection. In comparison, this physician can get *complete* protection against *any* lawsuit, in *any* amount, for the *rest of his life*, for less than one-fourth of what he pays each year for malpractice insurance. So, which is the better deal…insurance or asset protection? You can't think of asset protection as an expense. It's an investment — a great investment — if you truly want financial security!

CHAPTER TWO

Asset Protection Fundamentals

There's a saying that if you ask five attorneys the same legal question, you could get a different response from each one. The same could be said regarding asset protection. This "same question, different response" phenomenon is partially due to the fact that in the U.S., laws are constantly evolving and changing, that asset protection is as much an art as it is a science, that there is more than one way to effectively protect an asset, and that one must always consider the laws of the state in which a client lives as well as federal law. Despite the foregoing, there are some fundamental components every sound asset protection program shares. In this chapter, these concepts will be broken down and examined one by one.

Asset Protection Defined

Asset protection, simply put, is a strategy to title or encumber your savings, property, business and other assets in a manner that shields them from creditors.

The 'What', 'When', 'Where', 'How', and 'Why' of Asset Protection

Asset protection is much more complex than most people, and even some planners, give it credit for. Less effective planners which, unfortunately, are most asset protection planners, will only address the "what do we do and how do we do it" aspects of asset protection. However, there are five dimensions that must be addressed in order to construct a truly effective plan: the What, When, Where, How and Why of asset protection.

The "What" of asset protection covers the most fundamental strategies. There are only three and they will be examined shortly.

The "When" of asset protection deals with when a plan is implemented in relation to a creditor threat arising. If one implements a plan before creditors threaten, the plan may be relatively simple yet still effective at repelling future creditor attacks. Putting a plan in place after storm clouds have gathered usually requires more sophisticated planning and often more extreme measures, and sometimes (depending on the circumstances) the plan has a lower likelihood of succeeding. The "When" of asset protection primarily deals with Fraudulent Transfer Law, which we discuss in Chapter 5.

The "How" relates to how we implement the three core strategies. Ten chapters in this book (outlined below) address the "How" of asset protection. The "How" of asset protection also deals with how a plan is maintained once it is in place.

The "Why" of asset protection is examined in-depth in Chapter 18 (Asset Protection a Judge Will Respect). In short, the best asset protection plans have an ostensible, viable, bona fide reason for being implemented other than asset protection; asset protection is merely the icing on the cake, so to speak. Asset protection only for asset protection's sake may lead a judge to consider the planning an attempt to delay, defeat, or hinder a creditor, which is a violation of fraudulent transfer law. In this instance, the judge typically sets aside the plan, allowing a creditor to reach supposedly protected assets.

The "Where" of Asset Protection deals with choice-of-law, conflict-of-law, and jurisdictional issues. For a sample jurisdictional issue, consider that if assets are located outside the U.S., they are usually outside the reach of a U.S. judge. However, in certain cases where the person who controls the asset was within a judge's jurisdiction, the judge ordered that person to repatriate assets, and in extreme cases that person's non-compliance led to their incarceration.[11] An example of a choice-of-laws issue is as follows: if someone sets up a Nevada corporation, with Nevada-based management, yet the assets and stockholders live in Missouri, what laws will be used to determine how those assets are treated for debtor-creditor purposes when the stockholders are sued in Iowa? Finally, a conflict-of-laws issue could arise when a resident of a state (for example, Texas) is sued in federal court. Will Texas's unlimited homestead protection hold up when a Texas citizen is sued by the FTC in a federal suit?[12] The "Where" of asset protection is primarily examined in Chapter 8.

What We Do to Protect Assets: Three Core Strategies

Now, let's start with the basics. What can we do to protect assets? There are only three basic strategies:

1. **Exemption planning.** Exemption planning involves owning as many assets as possible that have some form of statutory protection from lawsuits and creditors. These assets are called exempt assets. However, not all exempt assets are equally protected. For example, an IRA may be protected in one state but not in another; nonetheless in bankruptcy it will almost always be protected up to $1 million in value. Furthermore, although protected against private creditors, an IRA is generally not protected against tax claims. An ERISA-governed pension, on the other hand, is almost always protected against tax claims while the plan is in non-payout status (which means the pension recipient has not reached the retirement age of 60 or early retirement age 55). Exempt assets are protected under federal law, state law, or both.

   There are four types of assets that are typically exempt:

   1) Personal residences (a.k.a. "homesteads");
   2) Personal effects (such as furniture and clothing);
   3) Pensions and retirement funds (IRAs, 401(k)s, annuities, etc.); and
   4) Life insurance.

The foregoing list is not all-inclusive. For example, in Texas wages are exempt from claims of private creditors (not including alimony or child support payments). However, this is the exception to the rule as most states do not protect wages. We must also remember that some protections are incomplete. Most states have a homestead law that protects one's home against creditors. However, while one state may protect one's entire homestead regardless of its value, another may only protect $5,000 equity in the property. Furthermore, while most states allow the transformation of wealth from a non-exempt asset to an exempt asset to be undone, if such transformation involves a fraudulent transfer, the Florida Supreme Court will not allow a homestead to be attached by creditors, even if the purchase of the home was done to delay, hinder, or defeat such creditors.[13] The bottom line is exemption planning is very fact and situation specific. How well your asset is protected under exemption laws depends on the type of asset, its worth, and the type of creditor that threatens it. A thorough research of case and statute law as applicable to a client's specific situation is a must in order to do proper exemption planning.

Exemption planning is more thoroughly examined in Chapter 6.

2. **Title your assets to a protective entity.** These entities, in one or another manner, prevent your judgment creditors from seizing the assets titled to the entity. Your assets may be titled onshore or offshore, or in a trust, corporation, or a spouse's name, for example. If a domestic plan is implemented improperly, it may be compromised due to fraudulent transfer or alter-ego (veil piercing) issues, which are discussed in Chapter 8. Offshore plans are typically compromised because management of the offshore entity was improperly structured (as discussed in Chapter 17), or, as mentioned earlier, a client could be held in contempt of court because he is ordered by a judge to repatriate an asset, fails to do so, and is unable to prove his inability to repatriate the asset (if in fact he is unable). Management structure and repatriation issues as applicable to offshore planning is discussed in Chapters 17 and 18, respectively.

3. **Encumber or equity-strip** your assets to reduce their economic value to and/or attachableness by a creditor. Equity-stripping involves the use of liens to transfer economic rights in property to a third party, although a client continues to hold title to the property along with (usually) possession and enjoyment of the property. Equity stripping is addressed in Chapter 15.

All of the above strategies can also fall into the category of either *transfer-based asset protection* (transferring an asset out of a creditor's reach), or *transformational asset protection* (transforming the asset into something a creditor couldn't get or wouldn't want). For example, part of one's salary can be placed into an ERISA-governed plan (401(k), etc.) that is exempt from creditors. Although this involves exemption planning, it also involves transferring cash into an ERISA-governed plan, and is therefore transfer-based asset protection as well. Another method involves using exposed cash to prepay certain expenses or repay favored creditors (so long as those creditors aren't "insiders" under applicable fraudulent transfer or fraudulent conveyance law). For example, one could take exposed cash and use it to pay in advance for a 5-year commercial lease. Such a technique, which results in the right to use an asset (the leased property), which right most creditors wouldn't want, is transformational asset protection.

Nearly every asset protection strategy relies upon one or more of these three core strategies, while simultaneously utilizing either transformational or transfer-based methodology.

When Is The Best Time To Do Asset Protection?

The best time to do asset protection is long before a creditor threat is foreseeable. This means you should do asset protection:

- At least 2 years before you file for bankruptcy.
- Well before your marriage turns sour and heads for divorce. Preferably, if you wish to do specific pre-marital/pre-divorce planning, and a pre-nuptial agreement is not an option, then it's best to set up your program before you get married. At the very least, do the planning at least one year before divorce seems likely.
- Before someone threatens you with a lawsuit.
- Long before your business starts going under.
- Before the IRS decides to audit you.

In other words, because we often can't foresee creditor threats before they occur, and asset protection is best implemented before these threats occur, you should set up an asset protection plan as soon as possible!

Can we do asset protection after threats to your wealth arise? Except as discussed below, the answer is often yes. But, your asset protection program will definitely be stronger if it's set up before your wealth becomes threatened. Furthermore, you may have to take more drastic and expensive steps to protect your assets after the threat arises. These steps may include sophisticated offshore planning with exclusively offshore managers, or even something like moving to Florida and buying a homestead property, (which is protected against creditors, even if the purchase of the home is deemed a fraudulent transfer.)[14]

When Is It Too Late To Do Asset Protection?

Generally speaking, it's too late to do asset protection once you have a judgment against you, unless you arrange to pay off the judgment (and you follow through with that arrangement) and are merely planning in order to safeguard assets against future creditors.

Doing asset protection planning to thwart collection attempts post-judgment may result in you and your asset protection planner being fined, meaning you're worse off than if you hadn't done any planning. Don't do it!

Doing asset protection planning in anticipation of a judgment, bankruptcy, or divorce is possible, albeit tricky, if the storm clouds are already on the horizon, due to fraudulent transfer law (discussed in Chapter 5). It's much, much better to do the planning before such threats arise. However, asset protection planning in these circumstances is often still very effective — but be careful! Egregious or blatant planning may result in fines and penalties. Our rule of thumb is if creditor clouds are on the horizon, retain a local attorney and have him hire the planner, so that attorney/client privilege covers the plan's implementation, and so that it's not apparent that you hired an asset protection planner (instead, you hired a local attorney, who then hired the planner; this allows the planner to work 'behind the scenes'). Because most of the best planners have a nationwide clientele and are therefore not always completely familiar with the laws of a given state, it's a generally good idea for a planner to work under a local attorney, regardless, even if that planner is an attorney himself (the exceptions being if the attorney is licensed in the state the client resides in, or in the state the client has assets).

How We Implement Core Strategies: Eight Asset Protection Firewalls

These three over-arching concepts are implemented by using eight specific mechanisms. We refer to each mechanism as a 'firewall,' because each in its own way and serves to insulate assets from creditors.

The firewalls include:

1) Federal and state exemption planning (Chapter 6)
2) Co-ownerships (Chapter 7)
3) Corporations (Chapter 8)
4) Limited partnerships (Chapter 9)
5) Limited liability companies (Chapter 10)
6) Trusts (Chapters 11 through 14, inclusive)
7) Offshore variations of firewalls three through six. (Chapters 10, 12, and 17)
8) Equity Stripping via Debt or Obligation-Based Liens (Chapter 15)

Each firewall has its own unique characteristics; strengths and weaknesses, advantages and disadvantages, applications and instances where they would not be used. Knowing which tool to use for which situation is what sets a skilled asset protection planner apart from the imposters who are far better at marketing asset protection than actually doing it.

Countless Opportunities

This foregoing does not suggest that every asset protection device can be neatly categorized. There are literally hundreds or even thousands of variations on the theme, but most entities and strategies conceptually, at least, fall within one of these firewall types. For example, limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs) are variations on limited partnerships.

Neither does every possible firewall fall within one category or another. For example, exposed cash may be used to buy a deferred annuity that will create an income stream many years hence. While the annuity payment may theoretically be claimable by the creditor (assuming its ownership falls under a jurisdiction that does not exempt such payments), how much is it worth to a creditor who must wait years to collect?

Although this book is comprehensive in that it examines all major protective strategies, as well as some highly effective yet lesser-known strategies, we don't aim to survey every nook and cranny of the asset protection world.

Using Multiple Firewalls to Layer Protection

No matter how safe or defensible a particular firewall may be, there is always the possibility that a creditor can find a way to pierce it. That is why we endeavor to layer our protection with multiple firewalls. It is the 'belt and suspenders' approach to protection. Even if one firewall fails, we have others behind it, and always the opportunity to impose still others should the situation warrant. Planners refer to this layering strategy as *defense-in-depth* planning.

A challenge common to all asset protection planners is not only to know which firewalls to use, but when to interpose additional firewalls as the creditor threat advances; one must always stay at least two steps ahead of any creditor in pursuit. Consequently, asset protection frequently evolves in stages. We have the *preventative* and *crisis* stage. Hopefully, a client will complete his or her plan before incurring liability. One should then only need a good preventative plan, or a basic first level of protection. The most important aspect of a preventative plan is it transfers, encumbers, or converts an asset into a more protected or exempt asset, so that when creditor threats later arise, a fraudulent transfer argument is much less likely to succeed. As we'll discuss in this book's chapter on fraudulent transfers, if the first transfer is not fraudulent, then neither are any subsequent transfers. This allows us to do further crisis planning (after a creditor threat has materialized) to keep assets protected even if the preventative plan is somehow pierced. Subsequently, a preventative plan will not necessarily be one's final plan if one is later sued, because an ultimate plan must provide all the safety one needs against the particular threat. Therefore, as threats arise, we would add more firewalls depending on the nature of the threat, to make one as judgment-proof as possible before he or she walks into the courtroom.

Until we know of a particular threat we cannot prescribe one best defensive position. How one is ultimately protected will greatly be influenced by the amount and nature of the claim, the dynamics of the case, what the creditor will likely do to seize assets should s/he win a judgment; and other factors that we will soon discuss.

Cost-efficiency and the goal of simplicity are also reasons to begin with a basic preventative plan. Not everyone gets sued, nor is every lawsuit wealth threatening, and even those that are may be covered by insurance or quickly disposed of through a reasonable settlement. Layering, then, usually progresses with the advance of the threat. To over-build a plan prematurely is to lose flexibility and to burden the client with needless cost and complexity.

Inevitably, we must create the plan with a high safety factor, as no plan is 100 percent guaranteed. If we are early on with a legal problem, we'd want to know what an ultimate plan would be should such planning become necessary. Clients with current or looming creditor threats always want to know what can be done to eventually achieve that safety factor. They must know what their firewalls will be, when we would add each firewall and how and why those firewalls work to insulate their assets. Understanding their ultimate game plan — not necessarily implementing the plan prematurely — lets clients sleep well.

When you layer or combine firewalls, you exponentially strengthen the final plan. A bulletproof vest consists of multiple layers of Kevlar; the layers working together are much stronger than the sum of each layer's individual strength. The same concept applies to asset protection. To illustrate, the combination of the limited partnership, offshore trust, Nevis LLC and foreign annuity into one integrated plan interposes a collectively formidable firewall barrier. There are, of course, hundreds of layering possibilities.

Managing Risk Through Diversification (a.k.a. Don't Place All Your Eggs In One Basket)

The deployment of assets in separate protective baskets is still another axiom of good planning. This is called diversification planning. As defense-in-depth planning creates multiple layers to pierce, diversification planning creates multiple targets for a creditor to chase. Figure 2.1, on page 30, illustrates how defense-in-depth planning and the diversification strategy work both separately and as an integrated plan. The bottom line is a creditor who must chase assets in several different directions is severely handicapped. And even if the creditor succeeds in recovering from 'one basket,' the wealth sheltered by the other 'baskets' remain safe.

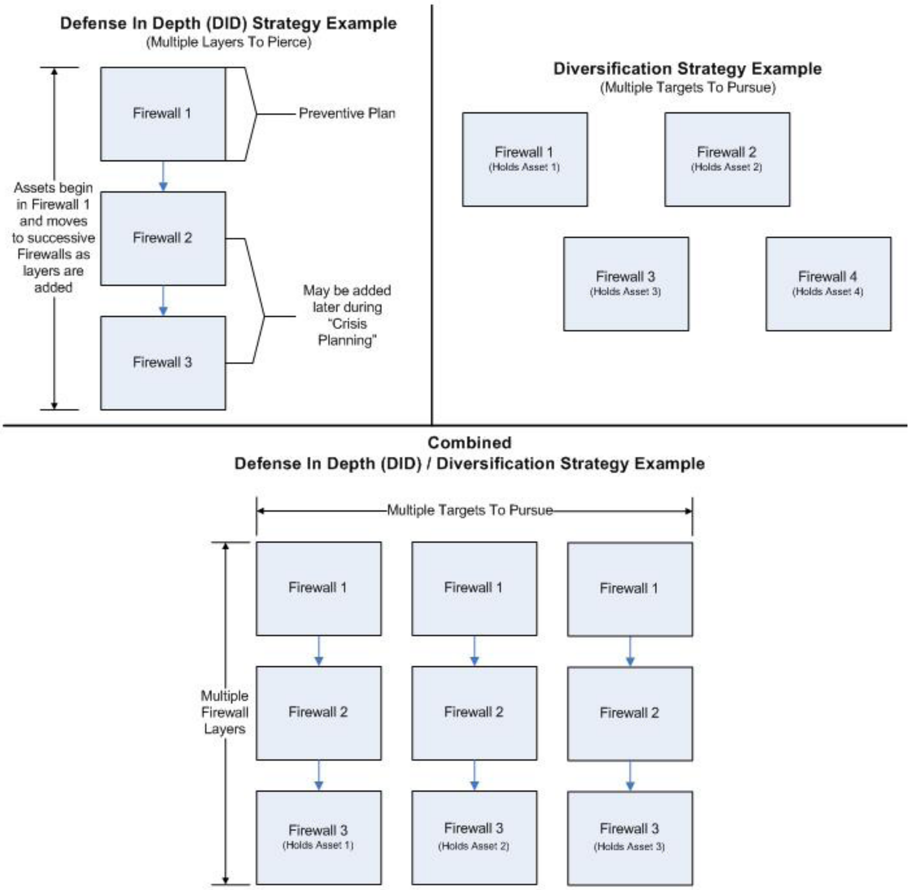
Diversification is particularly important where more wealth needs protection. For example, a client requiring maximum protection for ten million in liquid assets may deploy this wealth into five separate protective baskets that may be quite dissimilar to each other. It is this combination of layering or 'defense-in-depth' and diversification that creates the strongest shield. We must always combine and diversify firewalls to create an insurmountable obstacle to block even the most determined creditor.

Structure Firewalls with Counter Offensive Strategies

The best defense is a good offense. This truism applies to asset protection as well as to other conflicts. There are a number of ways to impose liability on a creditor who attempts to seize assets. For instance, a creditor who obtains a charging order (which may include foreclosing on the order) on a limited partnership or LLC interest may incur a tax liability while receiving nothing from the entity with which to pay the tax (this liability trap is discussed in detail in Chapter 19). Or, a creditor who wishes to commence litigation against a Nevis entity may be forced to pay a $25,000 bond before they can do so. There are any number of liability-imposing features that act as quills on the porcupine. It makes pursuit that much less attractive.

Seldom do the counter-offensive capabilities of a particular strategy control its adoption, but they may influence it. The goal is to present the creditor with a downside to pursuing the asset. In a nutshell, defense-in-depth and diversification strategies discourage a creditor from chasing assets by making the chase more difficult and the outcome uncertain, while counter-offensive strategies may make a creditor financially worse-off than if he had not attempted collection in the first place.

FIGURE 2.1


Defense In Depth (DID) Strategy Example
(Multiple Layers To Pierce)
Firewall 1
Preventive Plan
Assets begin in Firewall 1 and moves to successive Firewalls as layers are added
Firewall 2
May be added later during "Crisis Planning"
Firewall 3
Diversification Strategy Example
(Multiple Targets To Pursue)
Firewall 1
(Holds Asset 1)
Firewall 2
(Holds Asset 2)
Firewall 3
(Holds Asset 3)
Firewall 4
(Holds Asset 4)
Combined
Defense In Depth (DID) / Diversification Strategy Example
Multiple Targets To Pursue
Multiple Firewall Layers
Firewall 1
Firewall 1
Firewall 1
Firewall 2
Firewall 2
Firewall 2
Firewall 3
(Holds Asset 1)
Firewall 3
(Holds Asset 2)
Firewall 3
(Holds Asset 3)

Firewalls as Part of a Customized Plan

Despite the advantages of defense-in-depth, diversification, and counter-offensive planning, each component adds more complexity and cost to a plan. Therefore some of these strategies may not be appropriate for clients with a lower net worth or whose assets are not at immediate or serious risk. Obviously, then, there is no one right firewall, one right strategy, or one right plan. A client's plan must be customized to his or her own specific situation.

Above all, as this book will repeatedly and thoroughly demonstrate, there is no asset protection "magic bullet". There is no cookie-cutter plan that works for all clients. There's not even a cookie-cutter plan that works for a majority of clients. This is because the very best plans must account for all factors in a client's situation: tax issues, existing or nonexistent estate planning, solvency or insolvency issues, likelihood of divorce, retirement objectives, current and future business objectives, whether there are present creditor threats (and how severe the threats are and how determined the creditors are to collect their debts), likely future threats, likelihood of bankruptcy, and so on and so forth. Because there are so many factors to consider, the best plans are always custom-tailored to suit the client's needs.

For example, you will find planners who promote Nevada Corporations, a comparatively poor asset protection tool, as everybody's asset protection answer. Others suggest offshore trusts or limited partnerships for every client.

Each is only one of many tools, but that's all they are. It may or may not be the right firewall for *you*. Competent planners thus must offer the entire range of possible firewalls because any one firewall occupies only one place in the planner's toolbox. No one firewall is everybody's lawsuit-proofing answer. A planner must be adept at using every possible protective tool.

A planner must also offer both offshore and domestic (U.S.-based) protective strategies (if a client has a high net-worth, s/he probably needs both a domestic and offshore component to his or her plan). Not every planner has this dual expertise. Some planners only do offshore planning, which is more expensive and may not completely protect some types of assets, such as real estate located in the U.S. These planners will not be able to meet the needs of all clients. For example, offshore only planners may not be of service to those who are uncomfortable with offshore planning, those who have unprotected real estate in the U.S., or those whose net worth is not sufficiently high enough to warrant the extra expense of an offshore plan.

Domestic-only planners are also handicapped. The fact of the matter is there are some very strong economic incentives to going offshore, which we explore in Chapters 16 and 18 of this book. Indeed, with the imminent, grave financial problems the U.S. faces, it may someday be vital to one's economic well-being to diversify risk by placing at least some assets in non-U.S. dollar based offshore investments. A domestic-only planner's clients are very limited in what investments they may make that aren't based on the U.S. dollar. Consequently, a domestic-only planner will not be able to completely protect his client's wealth in the event of a hyperinflation or other systemic or currency-based catastrophe, which, among other things, could seriously devalue or even wipe out a domestic stocks and bonds portfolio. The arrogant attitude that the U.S. dollar is immune to hyperinflation or other devaluation not only ignores the fact that this phenomena has occurred in at least 30 countries since 1921 (or 21 countries since 1970),[15] but it also ignores the fact that hyperinflation has occurred *twice* in U.S. history.[16] Such an attitude further ignores the fact that our current economic situation shows a strong likelihood our country will again experience hyperinflation or other economic disaster within the next couple decades, as well as the fact that the U.S. dollar has already lost about 60% of its value vs. several other major currencies since 2001. Such doom-saying is no longer the opinion of fringe analysts, conspiracy theorists, or other extremists; warnings are now coming from a former U.S. comptroller general, former Federal Reserve Chairmen, ultra-wealthy billionaires, and U.S. congressmen and women.[17] We further explore hyperinflation and other economic threats in Chapter 16.

Some planners offer even more limited planning options by protecting only specific assets — and usually for self-serving reasons. That's how the planner makes money. For example, an insurance professional posing as an asset protection specialist may sell an accounts receivable financing program to protect this one asset from lawsuits. They push their programs at seminars targeted to doctors and small business owners. The accounts receivable finances a life insurance policy for which the planner earns a commission. The problem is this solution is not a good idea if the client lives in a state that offers little or no protection of life insurance from creditors. Furthermore, there are various tax and financial pitfalls that may make this solution unviable for certain individuals, which we explore in Chapter 15 of this book. Do you think a specialist who *only* does this type of planning will turn down business if his plan is not the best solution for a client? Of course he wouldn't. That's why the best plans are set up by planners who have a wide range of tools to choose from, and are thus able to choose the tool that's best for a client in a more unbiased manner.

Even if this factoring arrangement is a good fit for a particular client, how does one protect the client's many other assets? The point is a planner must have the complete arsenal of protective tools. Anything less is to lessen one's options and protection.

Customizing the right plan requires a planner to consider several factors:

- A client's state laws
- The nature and value of the assets to be protected
- The existing, most likely, or anticipated liabilities (if any) to be protected against
- Whether it is preventative or crisis planning
- If it is crisis planning, how aggressive is the creditor?
- The client's financial (estate planning, investment and tax) situation
- The strategies a client would be most comfortable employing
- Implementation and maintenance costs
- A client's personal situation (age, marital status, etc.).

It is the expert blending of these considerations into the one best customized plan for a particular client at a given point against a given danger that is the essence of good asset protection planning.

Keeping a Plan Updated

Finally, asset protection must be a continuous commitment. Frequently, people rush to protect themselves only when they are sued or anticipate a lawsuit. However, once the threat passes, they allow their plan to fall into disuse. Such a mistake can be costly. An asset protection plan is only the best plan at the given point in time it was first designed. Time brings changes. One's finances, obligations and personal situations change, as will the laws, available strategies and possible firewalls. Obviously, to keep abreast of these changes, an asset protection plan must also undergo change.

That is why asset protection planning must be a continuous and lifelong process. One must review a plan at least annually, and more frequently with each major event — a windfall inheritance, threatened lawsuit, relocation to another state, family change, etc. Each event triggers the need for an update. Only with continuous updates can a plan match one's current situation.

Yes, it involves time, cost and effort to enjoy strong lifelong protection, but that is what we mean by being committed to one's own financial security. If one's protection erodes because it is no longer a prime objective, one's wealth may once again become vulnerable.

CHAPTER THREE

Eleven Sound Planning Principles

Up to this point we've examined various components of asset protection planning. However, assuming these components are used, we must ask what distinguishes a *good* plan from a *great* plan — one that will give the optimum benefits and is ideal for one's particular circumstances?

No matter how diverse one plan is from another, each plan is built upon a solid foundation of underlying principles. These principles are discussed below as eleven principles to implementing the What, When, Where, Why, and How of asset protection planning.

There are also fundamental flaws that we sometimes see in plans. These errors may or may not compromise the safety of the client's assets, but they create adverse tax consequences, impose needless cost or complexity, or otherwise disrupt the client's other financial objectives.

Here are eleven principles to great planning:

Principle # 1 — Protect Every Asset (With One Exception)

It is axiomatic that an asset protection plan should insulate every important asset, but more than a few plans fail in this regard. They shelter only certain assets. Others remain exposed.

Why does this happen? There are several reasons. First, the client may overlook and not bring to the planner's attention such assets as intangibles (copyrights, patents, notes receivable, claims the client has against others, etc.). Second, some assets are exempt or self-protected and a planner therefore takes no further steps towards their protection. However, as noted earlier, some "exempt" assets are not protected against all creditors, are not protected to their full value, or are assumed to be protected when in reality they are not. For example, we oftentimes see this with retirement accounts where a client erroneously assumed they had statutory protection. One should never assume that an asset is protected. An advisor should confirm the protection of *every* asset. Nor should one think only in terms of protecting only *personal* assets. If one owns a business or professional practice, then its assets must also be protected.

For totality of protection one must also look forward and backwards. What *future* assets could materialize? (Inheritances, gifts, etc.). How can one protect *these* assets from creditor claims? Conversely, what major assets have been gifted or transferred over the past several years that may be reclaimed by a creditor as a fraudulent transfer? These questionable transfers must now be protected against foreseeable judgment creditors. The point: *Every* significant *past, present* and *future* asset must be identified and sheltered. Anything less is only partial protection.

The authors' web pages (*www.assetprotectionattorneys.com* and *www.pfshield.com*) offer a worksheet to help you inventory your assets. Estimate the value of each item, how each asset is presently titled (individually, tenants-by-the-entirety, joint tenants, tenants-in-common, in trust, etc.), and specify your ownership interest in any co-owned assets. Finally, list liens or encumbrances against each asset to determine the net equity that remains unprotected.

Some planners recommend leaving sufficient assets exposed to give something to the creditor. With one exception, we disagree with that philosophy. Why give the creditor any recovery, especially since those assets could then be used as a "war-chest" to fund an attempt to pierce your program.

There is an exception to the foregoing rule, however: if an asset protection plan is set up after creditor threat has materialized, and there is sizeable wealth that cannot be transferred offshore, then placing all of one's assets in domestic entities may be considered a fraudulent transfer. The Uniform Fraudulent Transfers Act, for example, states that a transfer is fraudulent if, in this instance, a certain amount of assets may be left unprotected and used as a reasonable settlement offer to the opposing party. If the remaining assets are protected, with careful consideration given to fraudulent transfer law, then the fact that some assets were offered to the creditor could go a long way to demonstrate one was not trying to hinder, delay, or defraud that creditor, and therefore the transfer of other assets are less likely to be deemed fraudulent. Nonetheless, even in this specific situation, such a tactic may not be advisable. Other factors must be measured, such as the creditor's aggressiveness, sophistication with fraudulent transfer issues, willingness to negotiate, and the attitude of a particular judge towards fraudulent transfers, for example.

Except as noted above, we may leave some assets of negligible value out of the plan if they cannot be cost-effectively protected. However, these same assets can seldom be cost-effectively recovered by the creditor.

Principle # 2 — Start With a Flexible Plan

There is no one plan that is equally effective against every potential claimant. Asset protection is much like football. You need the right defensive line to block a particular offensive line.

For example, protecting assets against a routine civil lawsuit would likely involve a far different strategy than we would use to maximize protection against the IRS or a divorce. And how one might protect one's assets against a small nuisance lawsuit would logically bear little similarity to where it was the government or another powerful litigant chasing a significant claim.

First and foremost, your plan must best protect one from any known or imminent threat; the danger that probably prompted you to seek asset protection in the first instance.

Beyond that, one cannot always foresee future troubles. That is why a good preventative plan should give the foundation of *basic* protection. From there you would add the specific firewalls to counteract each specific threat as it occurs. This requires flexibility so that a plan that can be easily built upon or modified to meet future situations. It is therefore important to understand the limitations of any particular plan and to modify the plan as necessary whenever a new threat appears.

Nor is there a 'standard' plaintiff even when lawsuits are comparable. Planners must assess how far the plaintiff is likely to pursue recovery. This, of course, cannot always be achieved with great accuracy and therefore it is always best to overestimate one's adversary. We also want flexibility because a client's personal situation constantly changes and some modification to a plan is necessary almost on an annual basis to accommodate those changes. There is also a constant stream of newer strategies and opportunities for asset protection. We then want to easily upgrade the plan.

Once a threat passes it may be desirable to partially dismantle the plan and return to the basic foundation. Maintaining excess firewalls may be overly costly and may not be necessary against a future claimant. In sum, we try to build a 'modular' plan — one where components can be speedily added, deleted or changed.

Principle # 3 — Keep it 100% Legal

Not too many years ago attorneys questioned the ethics and legality of asset protection. That has changed. Only the most naïve lawyer would today question the legality of asset protection planning and fewer still would question its necessity.

Nevertheless, there can be a grey area between legal and illegal asset protection. A good planner will not rely solely upon privacy, help a client conceal assets in a fraudulent manner, implement a plan that may require one to commit perjury, violate tax laws, money launder, commit bankruptcy fraud, or otherwise defraud creditors. That's not what good asset protection is about. We want legal protection, not 'protective' strategies that can only get both the planner and the client into even bigger trouble. If there seems to be something questionable about any proposed plan, seek the advice of qualified legal counsel. There are too many perfectly legitimate ways to shield wealth without the need to resort to questionable practices.

Too many people equate asset protection with secrecy — the concealment of assets — perhaps by titling the asset to privatized offshore entities or to some 'trusted' straw or stand-in. It is important to remember that secrecy is no longer a worthwhile standalone tactic because financial affairs cannot be fully privatized. The world today is too complex, and aside from hiding money in a coffee can buried under the oak tree, virtually any financial transaction can be uncovered. It is true that we may incorporate an element of secrecy into some of our plans and this may have value in discouraging a plaintiff from suing in the first place. However, once a creditor has obtained a judgment, they are entitled via a debtor's examination to honest answers concerning a debtor's finances. In this instance, anything but full disclosure is perjury.

Most asset protection plans are income tax neutral. They neither increase nor decrease such taxes. There are a few (usually associated with annuities and retirement planning) that can give you income tax deferral. Some promoters nonetheless sell pure trusts and offshore entities for 'tax savings'. One should be suspicious of any plan that supposedly saves one income taxes. Such plans should be reviewed by a CPA or tax attorney before moving forward.

Money laundering is another problem area. Transferring funds obtained by illicit means can give rise to money laundering charges. That is why planners, banks and other fiduciaries routinely follow certain due diligence or 'know your customer' rules, especially when offshore planning is involved. Rightly or wrongly, the government imposes this responsibility on us. Therefore, unless a client has a clean background, proper identification and several reference letters, s/he may have trouble retaining a planner.

Principle # 4 — Whenever Possible, Keep it Simple

For some planners, complexity is the hallmark of a great plan. We don't necessarily agree. Although the variables we consider that lead us to choose one strategy over another may be complex (after all, the best planners think holistically and weigh both federal and state law as well as estate planning and other concerns), the implementation and maintenance of the plan itself should usually be relatively straightforward. Whenever possible, simplicity is better. Over-planning is a chronic planning mistake. While layering multiple firewalls is necessary during times of duress, one can frequently accomplish an equal or even superior plan with less complexity. Not only may a simple plan give good protection, it will also cost less. More importantly, the simpler a plan, the better the odds are that clients and other advisors will fully understand and maintain it. The complex plan also incurs higher annual maintenance costs which may further encourage client disuse — particularly once the threat has passed. That is why it's generally preferable to start with the basic plan and add layers only on an 'as need' basis. Once the threat vanishes, we would disassemble to the basics.

There are many simple ways to protect assets — exemption planning and certain types of equity stripping (encumbering the equity in your assets) are two highly-effective examples. The goal is not to trade safety for simplicity; but to choose simplicity when a more complex plan gives you only comparable protection. The added marginal protection from a more complex plan must certainly equal or exceed its marginal cost.

Above all, a client must be able to fully understand their plan. Regardless of its complexity, an advisor should be able to explain the function of each component. If a client cannot understand their plan, it is too complex.

Principle # 5— Keep it Cost-Effective, But Don't Be Cheap!

Cost is always important to the design of an asset protection plan. No client seeks to spend more than is absolutely necessary to obtain protection. Therefore, economy and simplicity go hand-in-hand. On one hand, one does not want to spend more than necessary to achieve a particular level of protection. On the other hand, one does not want false economy only to end up with a faulty plan.

There are a good many low cost alternatives to more expensive structures and strategies. For example, the Nevis LLC (discussed in Chapters 10 and 17) can oftentimes provide superior protection to the offshore trust, which may be several times as costly. In addition, a number of judgment-proofing techniques (exemptions, tenancy-by-the-entireties, etc.) cost little or nothing to implement.

Cost, of course, is a function of both what plan is implemented and who the planner is. While a client may want to comparison shop different planners, it may be difficult to make accurate comparisons. There are many offshore incorporation services who could set up a foreign entity for less than the authors may charge, but does this entity include the same protective features as a full-fledged plan? Does such an entity come with legal advice, ongoing support and maintenance, integration of the entity into a multi-layered asset protection system (as well as integrating the plan into an estate, business, or retirement plan), assistance with re-titling assets into the entity, a risk analysis in light of one's current situation, structuring so as to avoid tax pitfalls, or advice as to whether one is even using the *right* entity? We cannot compare apples and oranges.

The lower price provider may prove to be no bargain. Is an offshore company organized by an offshore incorporation service really the best option? Are we simply buying protective entities or the expertise to know what structures and strategies should come together as an optimal plan? Again, the artistry metaphor; we need more than colors on a palette to create a fine painting. We must know how to apply them.

The better strategy is to compare the plans of different providers with comparable credentials and who will be providing a comparable scope of service. A cost-effective plan also bears proportionality between the value of the assets to be protected against the cost of protection. How much can one justify spending to shelter $100,000 in assets? How much more is justified for an estate worth ten or a hundred times as much?

Principle # 6 — Retain As Much Control as is Reasonably Possible

A common perception about asset protection planning is that such protection always requires a surrender of control over one's assets. That is sometimes true. However, it is frequently untrue. Much depends on the specific firewalls we use.

For instance, the limited partnership and limited liability company are two entities where a client may retain complete control and the assets within these entities will remain protected. Similarly, one would retain control over exempt assets and assets titled between husband and wife as tenants-by-the-entirety. Other methods allow one to control assets while having little or no control over recovering the asset from the asset protection structure. An example of this would be to place cash in an offshore LLC that purchases an offshore variable annuity. The client would retain control over how the cash is invested inside the annuity. However, the annuity policy would govern when, how much, and to whom annuity payments are made. We can even take things a step further, so that a client does not have the unilateral ability to withdraw annuity payments (after they've been made) from the offshore LLC (although he may exercise that right with the consent of an offshore manager or co-manager). Such measures would be important if it was necessary to prove a client's inability to repatriate assets to the U.S. per a judge's order, for example.

On the other extreme, it would be fatal to a plan if a client retained actual or *defacto* control over a trust created to protect assets. But even then, there are various control-retention techniques that should allay most of a client's fears about delegating control to a third party.

A good plan strikes an optimum balance between safety and control, an objective not always easy for a planner to achieve because many clients stubbornly want to retain control over their assets, even when it endangers their plan. While it is possible to achieve strong protection without sacrificing control, you will find that there are many ways to safeguard your assets even when you must entrust them to others. You gain considerably more planning options once you understand these control mechanisms and a plan can be customized for you that gives you greater control — or even complete control — while still adequately protecting your assets. How much control you can safely retain in any given instance must, of course, be determined by your advisor and it is always wisest to err on the side of caution. Oftentimes a debtor has little choice but to relinquish complete control over his assets to a third party (usually a professional trustee) if the asset is to remain safe from creditors. The client's discomfort with relinquishing control is abated by the reality that the other option is to keep the asset vulnerable. Which, then, is the less draconian alternative?

There have been a number of celebrated cases of asset protection plans (many of which we examine elsewhere in this book), usually involving offshore trusts, that had gone wrong only because the client insisted upon retaining too much control. One example in the case of *U.S. v. Grant*,[19] wherein Arline retained the right, as an offshore trust's beneficiary, to replace the trustee at will. Even though this trust was created 34 years prior to the creditor threat arising, the court subsequently ordered Arline to fire her offshore trustee and replacing him with a court-appointed receiver. Although this trust ultimately did succeed in safeguarding Arline's assets, this critical blunder almost caused the trust to fail.

There have been a number of celebrated cases of asset protection plans — usually involving offshore trusts — that had gone wrong only because the client insisted upon retaining too much control. The bane of the asset protection professional is this 'control' issue. It is most problematic in the planning process. It takes creativity to balance control retention with safety, particularly when the client is in crisis mode and the client insists upon retaining control. Certainly, education is part of the answer. A client who has greater confidence in the trustworthiness of the fiduciary will be more inclined to surrender control. But ultimately, the client must become comfortable with the arrangement; another alternative plan must be found or the client must be discharged because the planner can no longer bear responsibility for a plan that is unlikely to succeed.

Structuring management of an offshore entity (trust, LLC, or otherwise) is a critical control issue and is discussed in detail in Chapter 17.

Principle # 7 — Integrate One's Plan with Other Financial Goals

Asset protection is one important financial goal; it is not the *only* financial goal. Estate planning, tax, and investment planning (which includes retirement planning) goals are also important. It is these four financial goals that must fit together into one well coordinated, integrated plan. For this reason, Chapters 13, 14, 16, and 18 discuss setting up a plan that meets these other goals in addition to asset protection.

Asset protection should always be integrated with at least one or preferably all of the above. Not surprisingly, many clients who initially seek asset protection have no estate plan, not even a simple will. Asset protection then spurs creation of an estate plan. It also tends to expose tax inefficiencies as well as expose a client to greater investment opportunities. Where the client has an existing financial and/or estate plan, we must necessarily integrate the asset protection plan with this plan; which usually requires modifying the plan, at least to address the disposition upon death of the various entities we use for asset protection.

Principle # 8 — Create a Comfortable Plan

Another aspect of a great plan is that a client is comfortable with it. Or at the very least, the client's discomfort should be reduced to a low level. For some clients, the mere act of re-titling assets can be discomforting, particularly to those who are most comfortable with the status quo and a life of financial simplicity. More than anything else, however, it is relinquishing control, as we have already discussed, that is the major reason clients resist a proposed plan. We must then, if possible, maximize the control retention techniques (consistent with good asset protection).

Sometimes the planner cannot convince the client to accept a proposed plan because of client discomfort. We must then retrench to the next safest plan that the client will accept. There must be a psychological fit between the client and the plan. For example, the authors have had several clients from the Depression era generation. For some of them, high finance is saving their money in the largest bank in town. How comfortable do you think they would be moving their lifelong savings to an offshore trust in some small Pacific Island with a trustee from the Isle of Man? Do you see the disconnect? Ultimately, both the client and their planner must be comfortable with the plan.

The overly complex plan can also be unsettling only because the client doesn't fully understand the various components or how it all comes together. A series of circles and squares on a lawyer's legal pad may seem simple to the lawyer, but what does a client know about limited partnerships, offshore trusts or captive insurance companies?

A good planner educates the client as part of the planning process. In fact, that is one reason why the authors wrote this book. An educated client is a comfortable client.

Principle # 9 — Contain Liability

Asset protection must do more than protect particular assets from creditors. It is equally important for the plan to *contain* liability or insulate the client personally from business and other external liabilities and limit creditors to one (or the fewest number of entities). Essentially, this strategy deploys assets in different baskets so a creditor can target the least amount of assets. For example, a plan that shelters a business owner's personal assets is incomplete unless the plan simultaneously contains or limits creditors to the assets of the specific business entities.

Similarly, a great plan maximizes the concept of *transference*, or the shifting or sharing of liability to a third party. Many of the strategies in this book are useful to contain or minimize liability. Review the chapters that discuss corporations and limited liability companies for examples of its application.

Principle # 10 — Build a Plan That Works

Everything else is meaningless if your plan fails to achieve its primary purpose — to protect your assets. No planner can guarantee the absolute safety of their plan (and you should be wary of any planner who does); however, you want at least reasonable certainty that your assets can sustain a creditor attack, should it occur. Ultimately, you want your assets as close to 100 percent lawsuit-proof as legally possible. Anything less is *not* a great plan.

One of the authors was a pharmacist before he became an asset protection planner. In his former profession he dispensed sleeping pills. In actuality, asset protection planning is like dispensing sleeping pills. We compound the strongest possible asset protection plan, which allows our clients to sleep soundly. One cannot sleep soundly if one has only questionable protection. We must know how to build protection — if it becomes necessary — so that we are always one or two steps ahead of a creditor. When we understand why we *can't* lose our assets, we have a *great* plan!

Principle #11 — Use the Right Entity for the Right Situation

In our experience as asset protection planners, we've seen a lot of shoddy plans that have caused clients major headaches. Using the *wrong* entity for the wrong situation can not only cause a plan to fail when challenged, but it can also cause very painful tax consequences. Here are some examples of the wrong entities used in the wrong situations:

- Due to state laws, in 40 out of 50 states, if you want to protect your assets *and* you want to still have some control, enjoyment, or use of the assets, a domestic trust is the *wrong* entity to use (these types of trusts are called self-settled trusts). For example, the California Probate Code says, "If the settlor is a beneficiary of a trust … and the settlor's interest is subject to a provision restraining the voluntary or involuntary transfer of the settlor's interest, the restraint is invalid against transferees or creditors of the settler… If the settlor is the beneficiary of a trust… and the trust instrument provides that the trustee shall pay income or principal or both for the education or support of the beneficiary or gives the trustee discretion to determine the amount of income or principal or both to be paid to or for the benefit of the settlor, a transferee or creditor of the settlor may reach the maximum amount that the trustee could pay to or for the benefit of the settlor under the trust instrument..."[20] Translation: in this instance, a self-settled trust offers *no* asset protection.
- Even if you set up a trust in one of the ten states that allow self-settled trusts to protect assets, the assets are reachable by creditors until a statute of limitations expires, which is between two and four years after transferring property to the trust, depending on what state you live in. (The statute of limitations in bankruptcy, however, is ten years, and even then you're not guaranteed protection!) Furthermore, for these trusts to have any chance of working, the trustee, trust assets, and its creators must all be located in one of the states that allow self-settled trusts to protect assets. Failure to meet these criteria makes the trust vulnerable to having laws applied to it that would allow the trust's assets to be reached by a creditor.

- An irrevocable offshore trust should not hold non-liquid assets (such as real estate) that are located in the U.S. In this instance, a judge may rule that local laws apply instead of the laws where the trust was created. Since the laws of most states don't allow self-settled trusts to protect assets, the judge may ignore the laws of the offshore jurisdiction and turn the property over to creditors.[21]
- A corporation should not be used to hold a personal residence. If the home is taken out of the corporation and re-titled into the client's name, or if it is sold, the client will have to pay tax on gain. If the home was in the client's name, they could have been exempt from paying tax on gain[22] (the exemption is $250,000 for a single person or $500,000 for a married couple.)
- A personal residence should not be transferred into a limited partnership, or into an LLC that is taxed as a partnership. Although one can usually take the home back out of the partnership tax-free (as a distribution to the original owner), it is currently unclear whether one may nonetheless lose the $250,000/$500,000 exemption on gain when a personal residence is sold.
- Business entities in general are *not* for holding personal assets. Instead, one should use other tools such as equity stripping, exemption planning, or non-self-settled trusts. As one judge noted in the bankruptcy case *In re Turner* "a [business] entity or series of [business] entities may not be created with no business purpose and personal assets transferred to them with no relationship to any business purpose, simply as a means of shielding them from creditors. Under such circumstances, the law views the entity as the alter ego of the individual debtor and will disregard it to prevent injustice."[23]

CHAPTER FOUR

Benefits and Psychology of Asset Protection

The broad goal of asset protection should be to provide lifetime security against all threats to one's wealth. Exactly how asset protection accomplishes such while under fire is the subject of this chapter. We will also examine other fringe benefits of asset protection, such as improved estate, tax, and retirement planning.

Although some may think asset protection only "kicks in" after a judgment is awarded, such is actually the exception and not the rule. Most experienced litigators readily acknowledge that at least 95% of lawsuits are settled out of court. Settlements by their nature involve negotiating, and the most effective negotiating involves the psychological leveraging of a given set of facts and circumstances. Therefore, since the settlement negotiation process is the crucible wherein most asset protection plans are tested, by and large asset protection is most effective when utilized as a psychological leveraging tool.

Asset Protection as a Psychological Tool to Discourage Lawsuits

Before we discuss asset protection's role in negotiating a favorable settlement, however, we will examine how it often discourages lawsuits. Oftentimes asset protection 'works', before it is ever tested in a lawsuit, by preventing the lawsuit from ever occurring.

The cold hard reality of litigation, from an attorney's perspective, at least, is it's almost always all about the money. Attorneys work for a living and have bills to pay like everyone else. Although they often agree to represent clients on a contingency fee basis,[24] they will normally only do so if they believe they will get paid for their work. If a potential defendant has no assets to collect, the attorney won't get paid. Therefore, almost all plaintiffs' attorneys will first do an asset search on a potential defendant before offering their services on a contingency fee basis. If the search reveals little or no assets (perhaps due to financial privacy measures), or assets that are heavily protected, the attorney then becomes uncertain as to whether taking a case will result in him getting paid for his efforts. Even if the asset protection plan is pierced, the process of doing so may very well be a lengthy, expensive, and uphill battle. In such an instance, the attorney usually insists on an up front retainer of several thousand (or tens of thousands of) dollars before taking the case, or before pursuing the case beyond an initial filing. This of course shifts the risk of suing a defendant and losing or being unable to collect to the plaintiff, who suddenly finds their lawsuit to be a very expensive and risky undertaking! With the exception of lawsuits that have the potential for very large judgments against wealthy (albeit asset protected) individuals, attorneys and would-be plaintiffs will usually opt for easier prey. This is basic human and even animal nature, and we can see the same pattern among house thieves, for example, and even a pack of predators stalking a herd — they "case the house" or "stalk the herd" (akin to doing an asset search) and then usually go for the easiest kill. With that said, there are people who think they have strong protection when they actually don't. Sometimes the thief/predator/litigant is able to determine when an apparent defense is nothing but smoke and mirrors. The defendants are of course then surprised when they lose big, and they learn too late that they didn't just need an illusory asset protection, they needed solid, effective asset protection!

As asset protection planners, we have seen many asset protected clients threatened with litigation, only to have the threat fizzle and go away. The effectiveness of asset protection is perhaps most striking when there are several co-defendants on a lawsuit, and the asset protected clients are dropped from the suit even while it proceeds full-steam ahead against the remaining, unprotected, deep-pocket defendants.

Asset Protection as a Psychological Tool to Negotiate Favorable Settlements

Although asset protection often discourages lawsuits, it by no means guarantees their prevention in every circumstance. Very high net worth individuals in particular will find that some people are willing to take a gamble on suing them even if they have solid asset protection. Some plaintiffs are willing to take such a gamble because their target is extremely wealthy and must have *some* exposed assets. In other instances, a plaintiff will sue vindictively or for more personal than monetary reasons. Or, an individual is one of several defendants on a suit, and an asset search was only conducted on the primary defendant. Furthermore, some plaintiffs are taking the risk that their targets will settle a suit just for the sake of making it go away. After all, going to trial, or even the pre-trial discovery process, can be a very unpleasant experience. This is perhaps the most common psychological tactic they use: leveraging the defendant's fear of having to endure the litigation nightmare in order to get a quick, easy settlement.

It is true that despite our best efforts, a client may still get sued and may have to settle a case. Did their asset protection fail? The answer is no, not if the plan led to a settlement that was much lower than it would have been if they had no asset protection. In almost all cases, effective asset protection will lead to drastically lower "pennies on the dollar" settlements. After all, the psychological advantage we have is that, if a plaintiff fights to the bitter end, they very well may end up with little or nothing for their efforts. Therefore a plaintiff and his attorney will take what they can get, which may be only an insurance payout, and in such instances the defendant emerges relatively unscathed.

Interestingly enough, asset protection often works in a similar manner, but for different reasons, when the hostile creditor happens to be the IRS. This fact is confirmed by Maureen O'Dwyer, an international and large business examiner for the IRS, when she testified before the well-known Senate Committee Hearings on alleged IRS abuse on April 30th, 1998. The assertion that asset protection discourages IRS collection activity becomes abundantly clear from the following excerpt of her testimony:

"A[n IRS] manager who has an aging [tax collection or audit] case in his group will not receive an evaluation that will merit him a monetary award and help him carve out a career path within the Service …

The technically weaker managers consistently ordered cases closed, no-change, if they begin to age …

In large case CEP [Collection Enforcement Procedure] it is standard practice to drop an issue that will delay the closing of a case. Large dollar amounts on major taxpayers are routinely zeroed out in this manner. It matters not that there appears to be an egregious tax abuse, nor that the complexity of the issue requires time to develop. What matters is the manager receives a performance award for having met the case closing deadline timely…

… The cases that begin to age ordinarily have outstanding issues which have gone unresolved due to the complexity of the issues involved and the difficulty of their development, or due to the deliberate procrastination and lack of cooperation on the part of the taxpayer. *Therefore it can be seen that the cases which are closed, no change, under this statistically driven cosmetic deadline are usually large and* *wealthy taxpayers who have the means to consistently contend and dispute with the IRS.*" [Emphasis is ours.]

Therefore, even when a plaintiff is a person or agency that has almost unlimited resources, the psychology of asset protection is usually still at play.

How Asset Protection Works After You Lose a Lawsuit

Although solid asset protection will almost always prevent a lawsuit or lead to a favorable settlement, a dogged creditor may carry the suit to completion and then pursue assets aggressively. In this case, whether you win or lose the case is a bit of a crap shoot, especially if you are perceived as a deep pocket and you have a jury who wants to play Robin Hood (most do). If the worst happens, and you lose the suit with a large judgment award for the plaintiff, your asset protection program will now be put to the ultimate test. Fortunately, if your plan is solid and was set up long before the event that led to the lawsuit occurred, you will have little to fear. This doesn't mean the next several months or even years following the judgment won't have their rough spots. You may also have to defend your plan and justify its legitimacy, and if so required it is critically important to involve your asset protection planner in building your defense. However, as the creditor fruitlessly exhausts his remedies one by one, and as you cooperate fully and truthfully with the court throughout the process, the creditor will slowly realize most of your assets are simply untouchable. The creditor will eventually grow weary of getting nowhere, which will likely lead you back to the negotiating table where a favorable settlement is reached.

Using Liability Insurance in Tandem with an Asset Protection Plan

Liability insurance often works extremely well in tandem with asset protection in post-judgment circumstances. Oftentimes a creditor, once they realize how difficult it will be to reach your assets (if they can be reached at all), will simply take the insurance payout and leave your personal wealth alone. Thus, the time a creditor spends trying to collect against you post-judgment will often be much shorter and more painless if one has a good liability policy. Liability Insurance is thus a diversionary tool. It is an easy target readily available to a plaintiff, which diverts him from the elusive and hard to catch target: your asset protected wealth. Therefore, although some individuals wish to save money by reducing their insurance coverage after setting up an asset protection plan (which we discuss next), having at least moderate liability insurance is an essential component of a comprehensive asset protection program.

In addition to a general liability policy, it's often a good idea to purchase umbrella liability insurance. Umbrella liability insurance is designed to insure one against liability claims that may not be covered under other, more narrowly defined policies. It often only costs a few hundred dollars per year for $1 million or more in coverage, and we highly recommend this type of policy for all of our clients.

A Side Benefit of Asset Protection: Possible Reduced Insurance Costs

While we would never promote asset protection as a substitute for liability insurance, nevertheless certain high-risk professionals and businesses find their insurance costs to be prohibitive, or liability insurance may not be available. Asset protection can be complementary to insurance coverage, and may in some situations allow one to reduce their coverage to more affordable levels.

This does not suggest that one should forego liability insurance. While it is true that insurance may be costly and attract litigants, nevertheless insurance is invaluable in any risk management program. To the extent insurance is cost-effective, it should be the primary defensive tool and asset protection should be secondary. The overriding strategy is to focus the plaintiff on recovering only up to the policy and foregoing any further claim against the defendant — a goal more easily achieved when the defendant is, in fact, well-protected.

Asset Protection as a Catalyst to Improved Financial Planning

A good asset protection planner will look at all of one's assets and then integrate his plan into a client's estate, retirement, and/or business plan. Because asset protection works best when integrated into other types of planning, it is often the catalyst for solid financial and tax planning, if no such planning has been implemented, or it can serve to optimize, update, and streamline an existing plan. It is rare for this to work in reverse. In other words, rarely does the review of an estate or retirement plan lead to enhanced asset protection. Oftentimes the tax or other inefficiencies discovered in the course of asset protection planning will more than pay for the cost of planning itself. For example, we've often saved clients millions of dollars in estate taxes by identifying shortcomings in their estate plans, which savings they would have never realized had they not approached us for asset protection.

CHAPTER FIVE

Fraudulent Transfers

When an asset protection plan fails, it is almost always due to one of three reasons:

1) The entity is pierced (meaning a creditor of an entity is able to disregard the entity's limited-liability shield, and hold its owner(s) liable for entity debts).
2) The entity is reverse-pierced (meaning a creditor of an entity's owner is able to disregard the entity as being separate from the owner, and thereby attach the entity's assets to satisfy its owner's debt.)
3) The transfer of assets into an entity is deemed fraudulent. In regards to offshore planning, if #2 or 3 occur, then a creditor may be able to force the debtor to repatriate offshore assets, and the debtor could be subject to civil contempt consequences (i.e. incarceration) if s/he fails to obey the order.[25]

Of the above, fraudulent transfers are the most common reason for an asset protection plan's failure. This chapter defines and addresses fraudulent transfer issues. The chapter on corporations and limited liability concepts covers veil piercing, and the chapter entitled "Asset Protection a Judge Will Respect" addresses reverse-piercing and repatriation order issues.

A Brief History of Fraudulent Transfer Law

U.S. fraudulent transfer law is very well-developed. It originates from the statute of 13 Elizabeth, which was enacted in 1570. Even before that, fraudulent transfer issues were considered as early as 1376, when the Statute of Edward allowed creditors to void certain transfers their debtors had made as a means of avoiding their debt obligations. Of particular note, this statute considered what is known today as "badges of fraud", or indicators that a transfer was made to hinder creditors rather than as a result of one's normal course of business.[26] In the U.S., 13 Elizabeth (a part of U.S. common law) was subsequently replaced with the Uniform Fraudulent Conveyance Act of 1918 (UFCA), and since then 41 states have adopted the Uniform Fraudulent Transfer Act (UFTA), which was drafted in 1983.[27] Although these acts are based on a single uniform body of law, some of the states that ratified the Acts have made (mostly minor) changes to these Acts. ***Consequently, we must caution the reader that this chapter only discusses fraudulent transfer law in general; one must consult the fraudulent transfer law and associated case law of their state to thoroughly understand how any particular transfer might fare in a fraudulent transfer context.***

Fraudulent Transfers vs. Actual Fraud

The term 'fraudulent transfer' should not be confused with actual fraud. Actual fraud involves knowingly deceiving someone in a manner that causes damage.[28] A fraudulent transfer usually involves no misrepresentation to a creditor (typically no representations are made at all, for that matter, since the creditor is normally not a party to the transfer) and does not usually cause damage to a creditor. Furthermore, fraud is a crime whereas a fraudulent transfer, in most cases, is not.[29] Instead of fraud *per se*, then, a fraudulent transfer is the transfer of an asset so as to frustrate a creditor's attempts to collect a debt. The goal of the UFTA is not to punish, fine, or penalize the offender. Rather, it is a civil remedy that assists a creditor in recovering their debt, if the debtor has fraudulently transferred his asset(s). Nowhere in the UFTA is there any mention of a fine or other penalty for committing a fraudulent transfer. However, particularly flagrant fraudulent transfers have on rare occasion resulted in fines against the debtor as well as possibly his attorney or asset protection planner, which we'll discuss shortly.

Solvency, Reasonably Equivalent Value, Insiders, and Bright-Line Tests That Determine Whether a Transfer is Fraudulent

Sections 4 and 5 of the UFTA determine whether a transfer is fraudulent. From these sections, we may derive 3 types of fraudulent transfers:

1) Transfers that are constructively fraudulent as to present (already existing) creditors only;[30]
2) Transfers that are constructively fraudulent as to both present and future creditors;[31]
3) Transfers that are not fraudulent in and of themselves, but are fraudulent because they were made with intent to hinder, delay or defraud present and/or future creditors.[32]

Items 1 and 2, above, are determined by bright-line tests. In other words, these tests consist of clearly defined standards with little room for interpretation. The bright-line tests do not consider intent; one may commit a fraudulent transfer under these rules, even if one had no intention of hindering, delaying, or defrauding a creditor.

There are two primary criteria used to determine if a fraudulent transfer occurred under the first bright-line test. The first criterion requires that the debtor be insolvent at the time of the transfer, or becomes insolvent as a result of the transfer, or becomes insolvent shortly after the transfer.[33] Solvency, more or less, is defined as a person's ability to pay their debts.[34] If they are unable to pay their debts, or are currently not paying their debts even if able, then they are deemed insolvent.[35] It is important to note that, for purposes of determining solvency, any claim to one's assets could be considered a debt, even if the claim has not yet been reduced to judgment.[36] Therefore, if someone threatens to sue you for $1 million, their "claim" on your assets may be considered a liability for the purposes of determining your solvency.[37] In other words, if you have net assets worth $900,000, and are threatened with a $1 million lawsuit, you may be considered insolvent under the UFTA, even though you don't actually owe the $1 million (yet). Fortunately, solvency is *not* the only criteria for determining whether a transfer is fraudulent under the bright-line tests; one must also transfer the asset for less than reasonably equivalent value in addition to being insolvent.

The second criterion examines whether the debtor received an asset of reasonably equivalent value in exchange for the transfer. Reasonably equivalent value is generally considered to be cash or an item of equivalent cash value that is equal to the fair market value of the asset being transferred. The term 'reasonably' does give us some wiggle room, however an exchange (except in the case of a non-collusive foreclosure[38]) will usually not be considered to have reasonably equivalent value if the consideration for the transfer is worth less than 70% of the transferred asset's fair market value. Furthermore, an unperformed promise may not be considered to have reasonably equivalent value.[39] Therefore, if a promissory note is given in exchange for the transfer, it must be considered within the ordinary course of business of the lender (e.g. a bank giving a loan), or their should be at least a partial up front payment made, and ongoing cash payments should be made on the note so that it fits within the realm of a standard business transaction.

With the foregoing in mind, we can fully understand how the first bright-line test determines whether a transfer is fraudulent. This test stipulates that if a debtor is (or is about to be) insolvent, and he transfers an asset without receiving something of reasonably equivalent value in exchange, then the transfer is fraudulent. In this instance the transfer is fraudulent even if the creditor has no claim on the debtor's assets at the time of the transfer. A creditor could actually have no claim until just before the statute of limitations under the UFTA (or other applicable law) expires, and yet they could then still file a claim and the transfer would be deemed fraudulent.[40] This statute of limitations could be 4 years or longer after the transfer occurs, depending on the circumstances and local laws the matter is subject to.[41]

For us to fully understand the 2nd bright-line test, we must define what an insider is. The full definition of 'insider' is found in §§1(1) and 1(7) of the UFTA. However, a simplified definition of an insider is anyone who is a relative of the debtor, any company the debtor has significant control or influence over, or, if the debtor is a company or trust, anyone who has significant control over the company or trust. The foregoing, however, is not an all-encompassing definition of what an insider is. A court could conceivably consider anyone over whom the debtor has significant influence or control to be an insider.

With the foregoing in mind, the 2nd bright-line test involves a much narrower set of circumstances. This test, which only applies if the creditor challenging the transfer has a claim before the transfer occurred, shows a transfer to be fraudulent if the transfer was made to an insider to pay a debt that existed prior to the transfer, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.[42] This, of course, does not mean payment of a debt to a non-insider is a fraudulent transfer. On the contrary, paying off such a debt, as long as the debt is valid, is a great way to reduce the exposure of one's assets after the threat of litigation or other hostile creditor attack materializes. We'll discuss this strategy shortly.

Using Badges of Fraud to Determine Fraudulent Intent

The final criterion for determining whether a fraudulent transfer occurred is found in §4(1)(a) of the UFTA. In this case, a transfer is fraudulent as to present or future creditors if it was made "…with actual intent to hinder, delay, or defraud any creditor of the debtor." There is no bright-line rule here. Instead, a judge looks for indicia or "badges" of fraud that may indicate fraudulent intent. A judge has broad discretion in determining whether the presence of one or more badges of fraud indeed indicates a transfer is fraudulent. Furthermore, the standard of proof that must be met to indicate fraudulent intent is not the "beyond a shadow of a reasonable doubt" standard of criminal trials, but rather the less rigorous "preponderance of evidence" standard of civil litigation.

A partial list of potential badges of fraud is found in §4(b) of the UFTA, which are as follows (our comments are in italics below each badge of fraud):

1. The transfer or obligation was to an insider;

   This may or may not be a factor in determining whether a fraudulent transfer has occurred. For example, it is common business practice for someone to transfer personal property into a business they control (such as an LLC, LP, or a closely held corporation) in order to capitalize it; such a transfer, if done while creditor seas are calm, will almost certainly not be considered fraudulent, especially if the transferor receives an interest in the company that is equivalent to their capital contribution. On the other hand, transferring real estate to one's uncle the week before a lawsuit commences will likely be deemed fraudulent.

2. The debtor retained possession or control of the property transferred after the transfer;

   This may or may not be a factor in a fraudulent transfer case. For example, although a lien is a transfer of equity, mortgaged real estate typically remains in the owner's possession as a matter of standard business practice. In contrast, placing one's home in an offshore trust and then continuing to live in it rent-free is likely to be seen as a fraudulent transfer. Furthermore, secured personal property may or may not need to be possessed by the lien holder in order to avoid this badge of fraud.

3. The transfer or obligation was concealed;

   See the comment for badge of fraud (7), below.

4. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

   Some transfers (such as a gift to an insider) are very vulnerable to a fraudulent transfer ruling if they occur after a creditor threat arises. At the same time, no judge would expect you to stop your normal business activities once you've been sued, especially considering that a lawsuit may drag out for years. Of course, some of these business activities may involve transfers of assets. Consequently, if you are facing a lawsuit, it is important to transfer property so there is a plausible reason for the transfer, besides trying to protect assets. For example, by taking money and investing it in an LLC, you can protect the money while honestly claiming that you were just engaging in a business venture, instead of trying to defeat a creditor. At the same time, your claim of having a valid business purpose may be insufficient if other badges of fraud point to the fact that you did indeed transfer the asset in order to hinder, delay, or defraud your creditors.

5. The transfer was of substantially all the debtor's assets;

   This badge of fraud ties in to §4(a)(2)(i) of the UFTA. The most important consideration here is the need to avoid insolvency through a single transfer. Assuming one remains solvent, it is also a very good idea to stagger the implementation of an asset protection plan over time. For example, don't equity-strip all 5 of your rental units on the same day. Instead, it is best to have a few months' space between each transfer.

6. The debtor absconded;

   This is a very strong badge of fraud, which by itself would probably cause a transfer to be deemed fraudulent.

7. The debtor removed or concealed assets;

   Oftentimes there is a good reason for financial privacy, besides trying to defeat a creditor. Depending on your reasons, it may or may not be safe to conceal assets while the creditor seas are calm. However, this is usually not a good idea once one is threatened with creditor attack. Remember: everything can and will usually be revealed in court, and privacy is more for lawsuit prevention than anything else. Above all, remember that no plan should rely exclusively on secrecy, and that improper (but not all) financial privacy measures are usually considered a badge of fraud.

8. The value of the consideration received by the debtor was not reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

   This is why trusts are sometimes (but not always) a poor choice for protecting assets, since property is typically gifted into the trust. It is however possible to transfer assets into a trust in a manner that involves an exchange of equivalent value; we discuss how to do so in Chapter 12. This badge of fraud demonstrates that gifting in general is usually a bad idea from an asset protection standpoint. In contrast, when someone transfers an asset to an LLC, they receive an LLC membership interest in return. If done correctly, this membership interest constitutes an equivalent value of consideration received for the transfer.

9. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

   This is a strong badge of fraud, and it ties in with §§4(a)(2)(ii) and 5(a) of the UFTA. Implementing an asset protection plan and then failing to pay one's debts as they become due, whether through inability to do so or otherwise, is a big error.

10. The transfer occurred shortly before or shortly after a substantial debt was incurred; and

    Same as (9), above.

11. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

    This is a common technique used in the past to avoid fraudulent transfer rulings. The courts have obviously wised up to this. This badge of fraud ties in to §5(b) of the UFTA.

It is important to realize that badges of fraud are not black and white indicators. A judge is given wide latitude to interpret the types and number of badges of fraud present when considering whether a fraudulent transfer has occurred. On rare occasions a single badge of fraud will denote a fraudulent transfer, whereas in other situations multiple badges of fraud will not be enough to prove fraudulent intent. Regardless, in an asset protection program it is best to avoid badges of fraud whenever possible, the possible exception being when a badge of fraud is irrelevant since it occurs commonly in the regular course of doing business.

Above all, remember that the purpose of §4(b) of the UFTA is to help a judge determine whether a particular transfer smells fishy. If there's not a plausible economic reason for a transfer, and if the transfer is not a part of "business as usual", then it might not stand up if challenged in court, and such transfers will almost always carry at least one badge of fraud.

Strategies for Reducing the Likelihood of a Fraudulent Transfer Ruling

Because fraudulent transfer rulings are so detrimental to asset protection, it should be a planner's highest priority to structure their plan so as to, as much as possible, avoid the likelihood of such a ruling. The following are some strategies that can be effective in achieving this.

1. **First and foremost, get your assets out of your name while the creditor seas are calm, even if it's to a very simple structure.** As long as the entity itself is not a debtor, then a subsequent transfer by that entity will not be considered fraudulent under the UFTA. Accordingly, when creditor threat arises, you can then reinforce the entity or transfer the asset to a new entity, with reduced fraudulent transfer concerns. This is because the UFTA only considers transfers the debtor makes as being fraudulent.[43] Furthermore, restructuring an entity so that a creditor of the entity's owner cannot reach the entity's assets for its owner's debts usually does not involve a transfer, and is therefore not considered by the fraudulent transfer laws of most states. Even if it did, as long as the entity is not a debtor, then a transfer from the non-

debtor entity to another entity is usually not considered fraudulent under fraudulent transfer law.[44] This maxim is echoed on at least one occasion by the courts, as seen in *Lakeside Lumber Products, Inc. v. Evans*.[45]

In *Lakeside*, the court considered whether the restructuring of trusteeship (management) of a trust so as to deny a creditor access to trust assets was a fraudulent transfer. The controversy arose over a 1996 personal guarantee that the guarantor, Dan Evans, defaulted on. In 1989 he had quitclaimed his house into a living trust, with him and his wife as co-trustees and his wife as the sole trust beneficiary. After he defaulted on his 1996 guarantee, Dan relinquished control of trust assets by resigning his trusteeship (thus surrendering his power to take trust assets out of the trust to give them to a creditor; apparently Dan also retained no control to amend or revoke the trust as its grantor.) The plaintiff challenged the transfer as fraudulent, however the courts responded to the contrary:

> "With regard to the 1989 conveyance, Lakeside argues that two indicia of fraud are present: (1) Dan Evans transferred the home to an "insider"; and (2) Dan Evans has continued to reside in the home, effectively retaining control of the property. Assuming, without deciding, that Lakeside's contentions are true, we conclude that these indicia of fraud, considered in conjunction with "other factors," fail to create a triable issue of fact in this case. Crucial to our determination is the temporal remoteness of the 1989 conveyance to both the 1996 guarantee agreement and Dan Evans's 1999 petition for bankruptcy. Lakeside has pointed to no facts suggesting that in 1989, or shortly thereafter, Dan Evans was insolvent or experiencing other financial difficulties. Likewise, there are no facts in the record that would suggest that the 1989 transfer was part of a larger scheme to defraud future creditors such as Lakeside. Based merely on the indicia of fraud cited by Lakeside – transfer to an insider and retaining control of the transferred property – a jury could not rationally conclude that Dan Evans transferred the property with an intent to defraud creditors… Lakeside contests the district court's conclusion that the 1997 amendment to the trust was not a transfer, but simply a modification of the trust agreement. Under the Act, a transfer is defined as "every mode … of disposing of or parting with an asset or an interest in an asset."… We conclude that these actions did not effectuate a transfer... Dan Evans did not part with an asset or an interest in an asset by signing the quitclaim deed as a trustee. The purpose of the amendment and the quitclaim deed was to reflect Dan Evans's resignation as trustee. The district court did not err in determining that the 1997 amendment was not a transfer."

In light of the above, we can clearly see that setting up a structure far in advance of creditor attack will likely keep the transfer from being deemed fraudulent, even if there are multiple badges of fraud associated with the transfer. Furthermore, restructuring a non-debtor entity, even after the debtor becomes insolvent, is not likely to be considered a fraudulent transfer, as long as the debtor never transfers any of his or her assets while doing so.

With that said, it's still far better to set up a proper structure rather than a faulty one from the very beginning. Although in our opinion it's less susceptible to failure than an actual transfer done after creditor threat arises, there is a chance that reinforcing a faultily structured entity against creditors may not work, if the reinforcement is done after creditor threat has materialized. The fact of the matter is Mr. and Mrs. Evans kept their home only because the creditor did not make the proper argument in court. At the time this case was decided, Utah law did not allow a trust in which the grantor (the person who transfers assets to the trust) remains a beneficiary to keep those assets safe from creditors. If the plaintiff in this case had convinced the court that Mr. Evans was, in fact, a beneficiary of the trust, then they probably could have attached their judgment lien to at least part of the home's equity. However, because they failed to demonstrate such, the home remained untouched. Long story short, Mr. and Mrs. Evans got lucky. A more sophisticated creditor might have prevailed. If this was the case, then in this instance the trust could have been reverse-pierced. A court might then treat a reverse-piercing as meaning the asset was, in fact, an asset of the debtor. Therefore, if the entity made subsequent transfers, then those transfers might actually be considered transfers of the debtor, and thus they could be deemed fraudulent under applicable fraudulent transfer law. We could, of course, reinforce a plan further to guard against this contingency, but such measures may be much more costly than if we had a solid structure in the first place.

Furthermore, although a restructuring of an entity is not a fraudulent transfer, per se, the restructuring may be challenged under laws other than the UFTA. For example, in *Walker v. Weese*[46] a debtor transferred millions of dollars in assets to an offshore trust, shortly after she defaulted on a promissory note. She was the protector of the trust, and consequently had the power to repatriate trust assets to the U.S. (this is *not* a good way to draft an offshore trust!) Upon being forced into bankruptcy, she resigned her position as protector. The bankruptcy trustee sought to, among other things, overturn her resignation and re-instate her as trust protector, so that he could then have the court order her to repatriate the assets. Although this case was settled before the court ordered the debtor's reinstatement as protector, the court noted:

> "Plaintiff correctly points out that a fiduciary position such as Protector of the Trust, unlike the assets in the Trust, is an intangible right with no intrinsic value. [Citations omitted.] The resolution of a claim involving an intangible right, such as one's position as the Protector of a trust or as the trustee of a trust, can be adjudicated within the equitable powers of a court."

Another example where reinforcement may fail is where one converts the nature of an asset (without effecting a transfer) into an asset that is exempt from creditor attachment under state law. This strategy may work in a state that doesn't have a fraudulent conversion statute, however in Florida and a few other states that do have such statutes,[47] a creditor may undo the conversion of a non-exempt asset into an exempt asset if s/he proves the conversion was done with fraudulent intent. Purchasing an annuity with intent to defraud creditors, for example, could be undone under the fraudulent conversion statutes, even though the annuity is exempt from creditors under Florida law.[48] Furthermore, although this tactic is more obscure, converting a corporation into an LLC may or may not be a fraudulent conversion, since corporate stock, which is freely attachable, is converted to an LLC interest, which is not attachable outright. It is important to note that nowhere in the Florida LLC Act is an LLC interest technically considered exempt from creditors. Rather, a creditor's remedy against the debtor-owner of an LLC is limited to the charging order.[50] Because a creditor remedy nonetheless remains, this tactic may not be considered a fraudulent conversion; we won't know for sure until the matter is decided in court.

The foregoing reinforces the fact that restructuring a faulty plan may or may not work, and it's best to do solid planning from the start, although it's certainly better to do faulty planning in advance of creditor attack than to have assets in your name when creditor threat arises. In addition to the foregoing, we must also note the psychological factors that would affect a judge in a *Walker*-type case over a case such as *Lakeside*. In *Lakeside*, the transfer was done long before creditor threat arose, and involved a claim of $200,000. In *Walker*, the transfer occurred shortly after the debt was due, and involved a claim of about $25 million. In circumstances where transfers occur after creditor threat has already arisen, we will usually see a court act more sympathetic to the creditor's motions than the debtor's. Furthermore, in larger cases the creditor's attorneys are often more sophisticated at challenging the debtor's maneuverings.

2. **Build up assets in a structure. Since these assets were never yours to begin with, there is no fraudulent transfer issue, period!** This approach works best with an income-producing business or investments. For example, if you own a business, then instead of transferring all profits to you, have another

entity own the business. You can then take enough money from this entity to pay your cost of living, and the rest can remain in the entity, where it can be invested and grown. Because this money remains inside the entity, the assets never came into your possession. Consequently, if you're sued there is no fraudulent transfer issue, period!

3. **If you do asset protection after a creditor threat arises, do all transfers so that you receive an asset of equivalent value in exchange for your transfer.** The trick here is to receive an asset that is exempt from creditor attachment in exchange for your transfer, or you could purchase an asset a creditor couldn't otherwise touch (such as an offshore annuity held in a properly structured offshore entity).[50] Remember, under the UFTA you have to not receive equivalent value for your exchange *in addition to being insolvent* for a fraudulent transfer to have occurred (unless, of course, a creditor can prove the transfer was done with intent to delay, hinder, or defraud the creditor per §4(a)(1) of the UFTA; fraudulent transfers are significantly more difficult to prove under §4(a)(1) than under the bright-line tests of §4(a)(2) and §5). In light of the above, after creditor threats arise it goes almost without saying that one should avoid gifting whenever possible!

4. **In addition to avoiding the badge of fraud in (3), avoid other badges of fraud whenever possible.** Not all transfers carry badges of fraud, even if the transfer incidentally protects the asset from creditors. For example, if one were to trade in their old car for a new, expensive leased vehicle, this transfer of cash for the lease (which will have little value to a creditor) will almost certainly not be considered a fraudulent transfer. Even if badges of fraud 4 (making the transfer after creditor threats materialized) and 9 (making a transfer while insolvent) are present. As long as the transfer is a bona fide business transaction for equivalent value with a truly independent party, badges 4 and 9, even if present, are much less relevant (nonetheless we should still avoid these badges of fraud if at all possible). Compare this to gifting your vehicle to your mother after creditor threat arises while one is insolvent, and then moving to another state in a hard to locate area and continuing to drive the vehicle. This type of transfer carries badges of fraud #1, 2, 4, 6, 7, 8, 9, and 10 – a dead giveaway of fraudulent intent, not to mention a failure of the UFTA §§4(a)(2)(ii) and 5(a) bright-line tests.

    A tactic we often use that avoids or minimizes badges of fraud is to transfer one's assets to an LLC or limited partnership in exchange for a limited (non-managing) interest in the entity. Under §1(7)(i)(B) of the UFTA, a company of which someone is only a limited partner or member is *not* defined as an insider.[51] We can also transfer assets to a corporation without the corporation being considered an insider, as long as the debtor holds less than 20% voting stock in the corporation, and s/he is not an officer or director[52] (however since corporate stock may be seized by a creditor, this is usually not a good idea.) Properly using this tactic will, at the very least, avoid badge #'s 1, 2, 3, 6, 7, 8, and 11, and will also pass both bright-line tests. Of course, you still have to worry about (and avoid to the greatest extent possible) badge #'s 4, 5, 9, and 10, but as long as the asset can have a valid business purpose, then this strategy definitely moves things in the right direction.

5. **Do you have other creditors who are not insiders? If so, and you come under creditor attack, then pay your non-hostile creditors off.** This is an excellent tactic that works even after creditor threat has arisen. The U.S. Supreme Court has even noted that "In many [States], if not all, a debtor may prefer one creditor to another, in discharging his debts, whose assets are wholly insufficient to pay all the debts."[53] Here's an example of how we could use this truism to our advantage: suppose you have a 5 year commercial lease on your office space. If you come under creditor attack, you can place some of your cash reserves beyond the hostile creditor's reach by paying off the entire lease balance. This works because you receive something of equivalent value for paying off the debt, which is your right to use the office space. Furthermore, per the terms of the lease contract a creditor almost certainly wouldn't be able to use your office space (nor would he likely want to) and he almost certainly wouldn't be able to get a court to force the landlord to hand over your payment, as long as the lease is a valid, pre-existing debt. You could also pay your anticipated tax debts through the end of the year. Do you think the IRS would *ever* give that money to one of your creditors? Do you think a judge would ever consider paying your taxes to be a fraudulent transfer?

6. **When is a fraudulent transfer not a fraudulent transfer? When you buy a Florida homestead so as to protect your wealth from creditors.** In a rather interesting decision, the Florida Supreme Court in *Havoco of America v. Elmer C. Hill*[54] decided that a "homestead acquired by a debtor with the specific intent to hinder, delay, or defraud creditors is not excepted from the protection of article X, section 4 [of the Florida Constitution, which protects homesteads from creditor attachment.]"[55] What this means is that you can buy a Florida home after creditor threat arises and, even if doing so is a fraudulent transfer, the creditor cannot touch the home as long as it's your bona fide homestead. This home is protected no matter what its value is. Therefore, a sure-fire way to protect $20 million in assets is to buy a $20 million homestead in Florida![56]

7. **If creditor threat has already arisen, then use a proper offshore plan to purchase a foreign annuity. This transaction will likely be protected under §8(a)(1) of the UFTA.** Although strategies 3 and 4 (above) minimize the likelihood a fraudulent transfer ruling, they don't completely eliminate it. Furthermore, strategies 5 and 6 may not protect all of your assets, or may

not be feasible. If therefore the strategies we've discussed up to this point are inadequate, and creditor threats already loom, then consider offshore planning.

The first thing you need to know about offshore planning is not all offshore plans are immune from creditors. In fact, most aren't, because most aren't set up properly. Several high-end, expensive offshore plans (all involving a straightforward transfer of assets to an offshore trust) have, in actuality, failed when put to the test.[57] The good news about offshore planning is your assets move outside a U.S. judge's jurisdiction. Therefore, when implemented in a careful and proper manner, offshore planning may work even if the transfer is deemed fraudulent. However, the bad news is while your assets are outside a judge's grasp, you are in the judge's grasp while you remain in the U.S. A judge could order you to repatriate offshore assets, and unless you can prove your inability to do so, he can incarcerate you for failing to do so. In light of the above, it is best to treat your offshore transactions as if they were still subject to U.S. law (because you are!) If the transfer is not voidable under U.S. law, then you don't even test the offshore aspect of your plan. In other words, you'll have other layers of defense that need to be breached before the offshore aspect kicks in. This is what asset protection planners refer to as multi-layered protection or defense-in-depth. In regards to this strategy, it's usually not wise to use an offshore asset protection trust as a first line of defense, because under the laws of 42 states, the trust's assets are attachable by creditors. This means a U.S. judge might not look too kindly on your offshore trust.

The trick is to avoid badges of fraud as much as possible, make your transfer an exchange of equivalent value, use charging order protection[58] (which is recognized under U.S. law, as opposed to a foreign jurisdiction's self-settled asset protection trust law, which isn't), and have a valid economic purpose for your transfer so as to demonstrate your transfer was done with an intent other than to defraud a creditor. After all the foregoing has been done, you still need to make sure your transfer offshore is done so that you can prove to a court it's impossible for you to repatriate assets, especially if you do offshore planning after creditor threats arise (thus, if your transfer is deemed fraudulent, you can't be held in contempt). The chapter in this book entitled "Asset Protection a Judge Will Respect" gives a more in-depth analysis regarding the critical matter of repatriation orders and offshore planning.

With the above in mind, there is a provision of the UFTA that gives a *proper* offshore plan a *lot* of power. This provision is so powerful that one may call it the "Holy Grail" of asset protection planning. It may be the *only* way to fully protect your assets if a storm-of-the-century lawsuit arises and you don't yet have an asset protection plan (which means anything you do is at risk of being deemed a fraudulent transfer under §4(a)(1) of the UFTA).

This provision is §8(a) of the UFTA. It states:

> "(a) A transfer or obligation is not voidable under Section 4(a)(1) against a person who took in good faith and for a reasonably equivalent value or against any subsequent transferee or obligee."

This is important to understand. The UFTA gives one and only one situation where a transfer is *not* voidable (meaning the transfer won't be undone) *even if the transfer was done with fraudulent intent:* the transferee must have given the transferor something of equivalent value for the transfer, and the transferee must have done the transaction in good faith.

Setting up an offshore trust or LLC by itself *does not* meet these criteria. Transferring assets to an offshore trust almost always involves a gift and therefore there is no exchange of equivalent value. Although an exchange of equivalent value is present when you capitalize an offshore LLC (you get an interest in the company in exchange for giving the LLC assets), the LLC will probably not be considered a transferee in good faith if you are the one who set up the company. For the good faith criterion to be met beyond dispute, the transferee must be a completely impartial party who does the transaction in their normal course of business. Fortunately, there is such a transferee: an offshore insurance company.

Let's examine the following scenario: An offshore insurance company manages $250 billion in assets and has been in business over 100 years. A creditor threat materializes, and you're caught unprotected or your asset protection plan is seriously flawed. Consequently, you place your liquid assets in an offshore LLC, and you take the equity out of your real estate and other assets by setting up and exercising lines of credit (LOCs) with the hard assets as security for the LOCs. You then place the LOC funds offshore as well. Your offshore LLC then uses these funds to purchase a foreign annuity from the foreign insurer. In doing so, you have accomplished the following:

- You've transferred your assets to a non-insider for something of equivalent value (the annuity contract) that has little or no worth to a creditor (after all, even if they could seize the annuity contract, which they couldn't, they'd have to wait years to receive enough payments to satisfy their judgment). There is a viable economic purpose for this other than asset protection (as is explained in the chapter entitled "Asset Protection a Judge Will Respect"), and therefore you make it harder for a creditor to prove the transfer was done with fraudulent intent.
- Because the transfer was made in exchange for an item of equivalent value, and the annuity purchase was in good faith in regards to the transferee (the insurance company), the transfer is not voidable under

§8(a) of the UFTA, even if the debtor did it to hinder, delay, or defraud a creditor!

- The foreign insurer is a large, reputable, and well-established, and is in a jurisdiction that not only does not recognize a U.S. court order, but forbids annuity contracts from being surrendered to creditors. This is almost certainly ample evidence that the debtor is unable to repatriate assets if the transfer is voidable, which greatly reduces the chance of being held in contempt if assets are not repatriated.

We must note that you may be able to use this strategy by purchasing a domestic annuity, however there are some problems with the domestic approach:

- Notwithstanding §8(a) of the UFTA, some states' laws (especially fraudulent conversion laws) may specifically set aside purchases of annuities or life insurance if done with fraudulent intent.[59]
- It is almost impossible to set up an annuity where payments are made to an LLC (or other entity the debtor could then receive distributions from) without that entity being subject to reverse piercing. For example, if an LLC received annuity payments, this might not be considered a valid business purpose for the LLC, and thus the LLC could be reverse-pierced. In comparison, an offshore structure *must* be used in order to purchase an offshore annuity, as the foreign insurer will not do business directly with a U.S. person. Consequently, if annuity payments are made to the debtor (or to an entity he holds an interest in), then a creditor may or may not attach those payments when they're made, depending on whether or not those payments are exempt from attachment in a particular state.
- Offshore planning has the additional advantage of placing assets outside a U.S. court's jurisdiction (assuming we can prove it's impossible to repatriate assets, of course.)
- Offshore annuities are much more flexible, and typically have a much higher rate-of-return than domestic ones.
- The offshore annuity may be exempt from creditor claims under foreign law.

8. **Remember to consult your state's statutory and case law regarding fraudulent transfers.** There may be subtle differences between your state's law and the UFTA that could work to one's advantage, or detriment, if one isn't careful. Merely relying on the UFTA in general may be a critical mistake!

When Is It Too Late for Asset Protection?

Before we discuss when not to do asset protection, we should examine when asset protection planning is safe. As long as the asset protection does not involve fraud or blatant illegal acts (such as hiding assets offshore without filing the required reports with the U.S. government), it is safe to do asset protection while the creditor seas are calm and the debtor is not insolvent as defined by §2 of the UFTA. In doing so, even flawed asset protection programs may have a fighting chance of holding up when challenged (such as the trust we discussed in *Lakeside v. Evans*[60] earlier in this chapter. Remember however that solid asset protection has a much higher chance of surviving scrutiny than flawed planning.)

Once creditor threat has arisen, asset protection may still be done, although our available options are now somewhat diminished. Nonetheless, the U.S. Supreme Court case *Grupo Mexican v. Alliance Bond Fund* states, "[we] follow the well-established general rule that a judgment establishing the debt was necessary before a court of equity would interfere with the debtor's use of the property."[61] Another court even noted that an attorney who represents a client under creditor attack should "protect [the client] from the claims of creditors, to the fullest permissible extent."[62] This obviously gives us some wiggle room, and an attorney may even have an *obligation* to recommend asset protection for his client in certain situations, however the key phrase is we must do our planning "to the fullest *permissible* extent". This means planning while under creditor duress should only be done while fully considering the UFTA. Furthermore, there are several pitfalls (as discussed below) that should be avoided at all costs.

This brings us finally to circumstances where asset protection should not be done. Planning done in these instances can not only cause a program to fail, but could result in additional fines and penalties against the debtor, the planner, and possibly professional discipline against the debtor's attorney. Such circumstances can be broken down into four categories:

1) Planning against a creditor who has a direct interest in the property;
2) Planning against a post-judgment creditor;
3) Planning that involves dishonesty, misrepresentation, or committing a fraud against the court; and
4) Planning that is a blatant and egregious fraudulent transfer under the UFTA.

Almost without exception, planning should not be done to protect an asset that a creditor has a direct interest in. Doing so could give rise to a civil conspiracy claim if two or more individuals are involved (which is almost always the case, since protecting assets typically involves a transferor and transferee.) For example, in *Miller v. Lomax*, an estate's executor (Mr. Lomax) conspired with the decedent's children to transfer assets out of the reach of the estate's beneficiaries. Because this was done to cheat the beneficiaries of an asset they had a specific right to, the court noted that the defendant was guilty of civil conspiracy as well as committing fraudulent transfers. This stands in stark contrast to planning done to protect assets from a litigant who is not a secured creditor, and who does not have a claim to any specific property of the debtor. In another case, *Lane v. Sharp Packaging System, Inc.*, the Wisconsin Supreme Court held an attorney liable for conspiring to transfer assets out of the reach of his client's former employee. Although the employee had a contractual right to a stock option purchase as a part of his employment agreement, the attorney advised his client to gradually transfer assets out of the company so as to make the purchase impossible. This was of course not only a fraudulent transfer of assets the employee had a direct interest in, but a breach of contract and a bad faith act by the company's board of directors. A third example an Arizona court of appeals case, *McElhanon v. Hing*[63]. In this case, an attorney conspired with his clients (who were two of three stockholders of a corporation, of which each stockholder held a one-third interest) to render their corporate stock worthless via a bankruptcy proceeding, which essentially defrauded the third stockholder of his interest in the company. The court found both the attorney and his clients guilty of civil conspiracy.

The second instance where asset protection planning should not be implemented is after a creditor obtains a judgment, except when the debtor arranges to pay the creditor and only does general planning, or planning to protect against other threats that have not yet been reduced to judgment. Again we quote from *Grupo Mexican v. Alliance Bond Fund*, which states that "before judgment (or its equivalent) an unsecured creditor has no rights at law or in equity in the property of his debtor."[64] This of course means that once a creditor has a judgment, then s/he *does* have rights to property of the debtor, and an attempt to thwart those rights will be viewed in a much harsher light than if asset protection was done pre-judgment, wherein "the debtor has full dominion over his property; he may convert one species of property into another, and he may alienate to a purchase."[65] Instances of post-judgment planning gone sour include *Morganroth v. Delorean*[66] (where sanctions were imposed on both the debtors and their attorneys for attempting to evade a post-judgment claim of another law firm's legal fees), *Fischer v. Brancato*[67] (where an orthopedic surgeon diverted his income post-judgment to his wife's corporation, and was thus held liable on civil conspiracy as well as fraudulent transfer rulings), and *Professional Collection Consultants Inc. v. Griffis* (which found the defendant guilty of civil conspiracy and committing several fraudulent transfers post-judgment via a series of title transfers, encumbrances via deeds of trust, and foreclosure sales of various real properties).

The third "don't" of asset protection does not involve a circumstance, but rather involves a type of asset protection planning. In a nutshell, no type of asset protection should be done if it involves the necessity of lying, misrepresenting facts, or committing a fraud upon the court. This is far different from dual-purpose asset protection (which is asset protection that has an estate, business, tax, or retirement planning objective in addition to asset protection), or asset protection that benefits from attorney/client privilege. This is asset protection that essentially involves perjury or the equivalent. Such activities may be dealt with harshly by the courts. For example, in *In re Complaint as to Conduct of Verden L. Hockett*,[68] an attorney was sanctioned for having his clients transfer assets to their spouses via expedited divorce proceedings. These divorce proceedings required the spouses to lie under oath as to the purpose for the divorce, which essentially meant they committed a fraud upon the court. In *In re Depamphilis*,[69] 153 A.2d 680 (N.J. 07/31/1959), an attorney was sanctioned for advising his clients to transfer cash to their uncle, purportedly to pay a pre-existing debt that in actuality did not exist. This of course involved misrepresentations under oath as to the nature and validity of the transfer. (Ironically, after the transfer was set aside as fraudulent, the sanctions arose when the attorney's client sued him for malpractice, meaning the sanction arose from an action brought by the very client he was trying to protect.) The fact of the matter is, a good asset protection plan does not require one to commit perjury or deceive a creditor. It also never relies exclusively on secrecy, and the privacy aspects of the planning are only used to prevent or discourage litigation. In other words, solid planning is always done so that, if required in order to comply with a discovery request or debtor's exam, the entire plan and all transfers are fully disclosed to the court. If the planning is solid, then the assets should remain outside a creditor's grasp even if the mechanics of the plan are fully exposed.

Finally, although rare, particularly blatant violations of the UFTA (that do not otherwise involve one of the three foregoing "don'ts") can lead to sanctions above and beyond setting aside a fraudulent transfer and paying the plaintiff's attorneys fees for doing so. *Such instances historically have always involved transfers done without consideration while the debtor was insolvent*, and there are often harsher sanctions against attorneys who are well-versed in the law and therefore, in the courts eyes, should have known better. In *In the Matter of Breen,*[70] a Florida attorney was disbarred for trying to protect his assets by filing four bogus liens against his property, and transferring assets to his friend (again, without receiving consideration in exchange for the transfer.)

In light of the above, some clients may be hesitant to do asset protection of any type once a creditor threat has materialized. This would be a grave mistake, as failing to do so at this point could cause them to lose their entire life savings — everything they have worked so hard their entire life to accumulate. Except when a debt has been reduced to judgment, or when doing asset protection would involve defrauding a creditor of their direct rights to property, it is not a question of *whether* to do asset protection so much as it is *how* to do asset protection. Because of the complexity of fraudulent transfer law (both under the UFTA, associated case law, and the variations of the UFCA and UFTA between states), a competent, experienced, and skilled planner should be engaged, especially when creditor attack is imminent. Asset protection is like brain surgery: it is not a "do it yourself" endeavor.

CHAPTER SIX

Exemption Planning

What is Exemption Planning?

Exemption planning is the process of reorganizing one's wealth so that much of it is protected (or "exempt") by law from creditor attachment, even though it is still owned by that individual. There are some asset types exempt under federal law, but most exemptions come from state law. Then there are bankruptcy exemptions, which may use federal and/or state exemptions, and which only apply in bankruptcy. The types of state-protected assets vary greatly from state to state. Furthermore, the extent to which assets are protected in a given state also varies. However, there are general categories of exempt assets. These categories include:

- A single personal residence (commonly referred to as a "homestead").
- Pension and retirement plans, which may be protected by state and/or federal law.
- Life insurance.
- Annuities.
- Items necessary for daily living, such as furniture, an automobile, and clothing (these items are usually only exempt to a few thousand dollars or less).

- Wages (only protected by a few states, but somewhat protected federally, as the section on wage exemptions discusses below.)

At first glance, you would think exemption planning to be simple. After all, if the law says an asset is exempt, then it's exempt, right? Not always. There are always exceptions, caveats, and conditions to the exemption laws. Knowing when an "exempt" asset is truly exempt from a certain creditor and when it is not is what separates the best asset protection planners from the mediocre masses.

Homestead Exemptions

The homestead exemption is a state law (or, sometimes, part of the state's constitution) that is designed to at least partially protect one's home from creditors. It is important to read the fine print in a given state's exemption law. For example, the Texas homestead exemption, which is touted by many, along with Florida's homestead exemption, as one of the best in the nation, still provides statutory exceptions as to when the exemption does not apply. The law says, for example, that the exemption does not protect against:

1) Property taxes.[71]
2) Liens arising due to an initial loan on the home, a refinancing loan, a reverse mortgage, or an equity line of credit.[72]
3) Mechanic's liens.[73]
4) Partition in the property as a result of divorce.[74]

What's more, many exemptions only protect a limited amount of equity in certain assets. For example, although Iowa, Florida, Texas, Kansas, and Oklahoma[75] protect 100% of one's homestead from creditors,[76] North Carolina only protects $18,500 of a homestead's equity.[77] Therefore, if one owned a North Carolina home having $300,000 net equity, a judgment creditor could foreclose on the home and seize any sales proceeds that are not covered by pre-existing liens or this limited exemption. Other than the states mentioned, a few states will not protect any home's equity, and other states protect varying amounts of equity.

The good news is that homestead protection is added on top of whatever mortgage secures a home. For example, if a home is worth $600,000, but it has a mortgage for $500,000 and is located in a state with a $50,000 homestead exemption, then only $50,000 of the home's value is exposed to creditors. This is because the mortgage is a lien that is secured specifically to the lien holder. It is there to ensure that the lien holder's debt or other obligation is repaid. Thus, the equity covered by a mortgage or other lien is unavailable to unsecured creditors (i.e. a creditor that does not have a lien on the property), or to secured creditors whose lien arose afterwards. Some individuals use mortgages or other types of liens specifically to protect their home from other creditors. We call this technique *equity stripping* and this book examines such in Chapter 12. Because the homestead protection and pre-existing liens are added together when calculating how much equity is available to subsequent creditors, some homesteads are mostly or completely protected even in states that don't offer complete homestead protection. At the same time, as a mortgage gets paid down or the property appreciates in value, more and more equity becomes exposed. It is dangerous to therefore think that just because a home's equity is currently covered by a limited homestead exemption that it will always be covered.

With that said, merely using a home as one's primary residence does not always mean that home is protected by homestead laws. Some states have additional requirements one must meet to claim homestead protection. Some states require their residents to file a declaration of homestead in a public office. Other states impose a short residency period before they grant homestead protection. In certain states, only the head of the household can claim homestead protection; however, most states allow either spouse to do so. If you are married, be careful. Sometimes when both spouses file homestead declarations, their cross-declarations cancel each other out.

There are other potential traps. For instance, in Florida, you may or may not lose your homestead protection if you title your home to a trust.[78] Tens of thousands of Floridians have been advised by their estate planners to title their home to their living trust to avoid probate, not realizing that doing so may make them lose their homestead protection. Unfortunately, few of these people realize their homes may now be lost to creditors.

Wage Exemptions

A few states exempt wages from creditors. Texas, for example, does not allow judgment creditors to garnish wages.[79] Florida protects wages if they are earned by the head of a household.[80] New York only allows 10% of wages to be garnished if the debt is less than $1,000.[81] However, these protections do not apply to child support payments, and as we'll discuss below, they also do not prevent federal tax garnishments.

Even if you reside in a state with less wage protection, the federal Consumer Credit Protection Act (CCPA)[83] nevertheless limits the amount a creditor can garnish from your wages. What's more, the Federal CCPA overrides state laws that provide less wage protection, so you can at least count on the protection of the

CCPA, and possibly greater protection if your state laws are more restrictive. The CCPA limits the amount of wages a creditor can garnish to the lesser of (1) 25% of the debtor's disposable income per week (*disposable income* is the net paycheck after deducting federal and state withholding and FICA taxes), or (2) The amount by which your weekly disposable weekly income exceeds 30 times the federal minimum hourly wage.[84]

Exemption Planning for Life Insurance and Annuities

As far as annuities and life insurance are concerned, such policies are only exempt in some states. Even in states that protect these asset types, they are often only exempt if structured properly. In some states we must not only pay attention to who the policy's insured person, owner, and beneficiaries are, but we must also examine the wording of the policy before we can say with any certainty that the policy is exempt. For example, Utah protects life insurance proceeds, but only if the beneficiaries are the insured person's spouse or children.[85] Alabama law protects life insurance from the claims of creditors of a policy's beneficiary, but only if the beneficiary is someone other than the insured person and the policy states that the proceeds are exempt from creditor attachment.[86] Not surprisingly, many insurance policies don't include such protective language. To further muddy the waters, some states address to what extent cash proceeds are exempt from attachment, and other states don't. If a state is silent on whether proceeds are protected, does that mean the policy is only safe from attachment before it's converted to cash? How long are the proceeds safe after receiving them? If statutory law is silent, we must then look to case law, which of course will vary by state. In any case, to be as safe as possible we should never commingle insurance proceeds with other funds. They should be kept in a separate account so that they're clearly identified and thus afforded the maximum protection under law.

Finally, we should consider fraudulent transfer law if planning is done after creditor threat has already materialized. Some states have adopted fraudulent conversion laws to specifically address whether transforming an exempt asset to a non-exempt asset in order to avoid creditors is fraudulent. If such is done after creditor threat has arisen, fraudulent conversion law (if a given state has such a law) tends to operate differently than fraudulent transfer law. This means that even if a transfer is not fraudulent under fraudulent transfer law, it may be fraudulent under fraudulent conversion law. In states with fraudulent conversion laws, whether a transfer is fraudulent will vary from state to state. For example, the purchase of a homestead in Florida, even if done to intentionally thwart creditors, cannot be undone as a fraudulent transfer or conversion.[87] Nonetheless this may not be the case in other states.

Because the exemptions for annuities and life insurance are very state specific, one must be very careful when doing this type of planning. However, in a state that lacks fraudulent conversion laws, protects life insurance and/or annuities, and has no case law that sets precedent for undoing the purchase of a life insurance or annuity contract as a fraudulent transfer (which is unlikely, due to §8(a) of the UFTA, which we discussed in Chapter 5), life insurance/annuity exemption planning even after creditor threat has materialized may very well work.

Exemption Laws as Applied to ERISA-Governed Retirement/ Pension Plans

An ERISA-qualified plan is a retirement savings account that meets the requirements of the Employee Retirement Income Security Act of 1974 (ERISA)[88], a law enacted specifically to protect the rights of employees enrolled in benefit plans sponsored by their employers or unions. A key requirement of ERISA is that the pension plan be structured as a spendthrift trust — one that prohibits the beneficiary from gifting, anticipating, or encumbering the plan's principal or income. Such a plan is then protected from creditors by ERISA's anti-alienation provision.[89] The most common qualified retirement plans are profit-sharing plans (a.k.a. defined contribution plans), pension plans (a.k.a. defined benefit plans), and 401(k) plans. These are plans in which the employee makes voluntary contributions to the plan.

For many years preceding 1992 there were mixed court decisions as to whether ERISA plans were creditor protected. Then a U.S. Supreme Court decision, *Patterson v. Shumate,*[90] solidified the protection for ERISA-qualified plans. The Court ruled that ERISA-qualified plans cannot be claimed by creditors, whether in bankruptcy, by lawsuit, or through other means. This decision applies to *all* ERISA-qualified pension and profit-sharing plans. Public pensions (those funded by state or federal government), though not necessarily protected under ERISA, have always been protected from creditors under their respective governing laws and regulations.

When an ERISA or Keogh Plan Will Not Protect Assets

Since 1992, several court decisions have somewhat eroded the protection granted retirement accounts under the *Patterson* decision. Furthermore, there are a growing number of cases where the plaintiff successfully argued that a 401(k) did not fully comply with Internal Revenue Code (IRC) and ERISA laws and regulations,[91] and the plan was thus unprotected. Most often, these plans were disqualified because the business owner or partner (and possibly his or her spouse) were the only participants in the plan. The courts reasoned that, due to Department of Labor regulations,[92] the owner or partner and his or her spouse are not employees, and if they are the only participants, then the plan is not an "employee benefit plan" because there are no employees.[93] Thus, such a plan is not ERISA-qualified, and they do not benefit from ERISA's anti-alienation provision. Such disqualified plans were then only afforded whatever protection other non-qualified plans had under state law. The courts have also ruled that these owner-only plans may be forfeit in bankruptcy.[94]

On the other hand, the U.S. Supreme Court ruled in *Raymond B. Yates, M.D., P.C. Profit Sharing Plan v. Hendon, Trustee,*[95] that if a pension or other retirement plan has at least one true employee in the business (a worker who has no ownership in the company), then the company owner(s) may be considered participants in the plan as well, thus qualifying their retirement funds for ERISA creditor protection.

With the foregoing in mind, most plans are ERISA-qualified as long as both the company owners and at least one other employee are covered under the plan. However, if you are uncertain whether your plan is ERISA-qualified, have your asset protection planner or plan administrator review your pension documents.

Generally, Keogh plans with multiple participants have the same lawsuit protection as ERISA-qualified pensions. Most likely, your Keogh plan is lawsuit-proof.

However, sole-participant Keogh plans are vulnerable for the same reasons that ERISA-governed plans are. The courts routinely allow creditors to seize sole-participant Keogh funds because the beneficiary/debtor can voluntarily withdraw the funds and the beneficiary/debtor is his own trustee; therefore no one other than the debtor would be affected by the seizure.[96]

Assuming your plan is ERISA-qualified, does that mean it is safe from all creditors? Unfortunately, and contrary to popular belief, ERISA plans are not the holy grail of asset protection in all instances. Although ERISA's anti-alienation clause provides very, very strong protection against private creditors, there are statutory provisions that make clear ERISA-governed plans are not safe from the following:

- Federal tax claims.[97]
- Federal criminal fines and restitution orders.[98]
- Child support payments, alimony payments, or forfeiture/division of the plan due to divorce.[99]
- A criminal or civil judgment, consent order, decree, or settlement arising from a plan participant's fiduciary violation or crime against the plan. (In this situation, only the offending party's portion of the plan may be forfeit.)[100]

Some of the foregoing may lead to an attachment of ERISA-governed pensions, notwithstanding ERISA's anti-alienation provision, because they are clearly allowed to do so as a matter of law. However, the reasons why a creditor may attach ERISA-governed funds due to a federal tax claim or federal criminal fine or restitution order should be explained in more detail. Federal tax claims may attach ERISA-governed accounts because of a treasury regulation and also a provision found in ERISA itself. The treasury regulation states:

> "A plan provision satisfying the requirements of subparagraph (1) of this paragraph [which includes ERISA-qualified plans] shall not preclude the following:
>
> (i) The enforcement of a Federal tax levy made pursuant to section 6331.
>
> (ii) The collection by the United States on a judgment resulting from an unpaid tax assessment."[101]

This statute should also be read in conjunction with the ERISA provision that states:

> "Nothing in this subchapter shall be construed to alter, amend, modify, invalidate, impair, or supersede any law of the United States… or any rule or regulation issued under any such law."[102]

Because ERISA, by its own definition, cannot impair another law of the United States, and the IRC regulations allow ERISA-governed and other qualified pensions to be attached, federal tax liens may attach to ERISA-governed funds, and the courts have agreed on this matter.[103] (We will briefly examine *McIntyre v. USA*, below, which is one of the cases that reached the foregoing conclusion.)

In addition to the foregoing, recent case law has allowed federal criminal fines and restitution orders to attach ERISA-governed pensions. This is based on the courts' interpretation[104] of Title 18 USC §3613(c), which says:

> "A fine imposed… or an order of restitution [ordered due to a federal criminal offense] is a lien in favor of the United States on all property and rights to property of the person fined as if the liability of the person fined were a liability for a tax assessed under the Internal Revenue Code of 1986."

Because tax liens attach to ERISA-governed funds, and a criminal fine or restitution order is treated as if it were a tax lien, such a fine or order supersedes ERISA's anti-alienation provision.

ERISA plans whose beneficiaries reside in community property states are even more exposed to ERISA's anti-alienation loopholes. This is because a creditor threat to either spouse could reach either spouse's ERISA plan, if the plan is not otherwise protected by federal or state law. We see this clearly in *McIntyre v. USA*.[105] In this case, Jerry McIntyre's ERISA-regulated pension was subject to a $300,000 IRS levy for taxes owed from 1983-1995. Jerry's wife Waltrout claimed that because they were California residents, she owned half of Jerry's pension under the state's community property laws, and since the IRS could only levy against Jerry's property, her half of the pension should remain untouched. Furthermore, she argued, ERISA's anti-alienation provisions forbade the IRS from levying protected pensions. The court proved her wrong on both counts. It states:

> "…the Internal Revenue Code expressly indicates that no other federal law shall exempt property from the IRS's authority to levy a delinquent taxpayer's property… Moreover, ERISA's anti-alienation clause cannot prevent the IRS from undertaking what would otherwise be a valid exercise of its levy authority … ERISA itself has a saving clause that states: "Nothing in this subchapter [which includes the anti-alienation provision] shall be construed to alter, amend, modify, invalidate, impair, or supersede any law of the United States." … We think it is plain that the IRS's authority to proceed against a delinquent taxpayer's interest in benefits from an ERISA-governed plan is not constrained by ERISA's anti-alienation provision."

In regards to Mrs. McIntyre's claim that the IRS couldn't levy on her half of the pension fund, the court noted:

"[California] Family Code S 910 … establishes that:

> '*the community estate is liable for a debt incurred by either spouse before or during marriage,* regardless of which spouse has the management and control of the property and regardless of whether one or both spouses are parties to the debt or to a judgment for the debt.'" [Emphasis is mine.]

As if things weren't scary enough, the court also said that in this instance federal law would not pre-empt state law (further eroding the protective features of ERISA's anti-alienation provision):

> "ERISA's anti-alienation provision plainly does not preempt the operation of California law insofar as it vests in the husband a continuing property interest in his own pension benefits..."

This means, of course, that if a state's community property law makes community property vulnerable to debts incurred by either spouse, then ERISA's anti-alienation provision will not protect the plan from a creditor of the spouse of the plan's beneficiary any better than it would from a creditor of the beneficiary.

Exemption Planning for IRAs

In most states, IRAs are significantly less secure than are ERISA-qualified plans and Keoghs. An IRA is a custodial account set aside for its owner, who can withdraw the funds at any time (although a 10% penalty applies if the funds are withdrawn before the owner is 59½ years old).[106] Since IRAs have neither a 'spendthrift' provision nor trustees, there is no federal protection for IRAs. Also, because the owner can liquidate the IRA, the courts have routinely ruled that the owner's creditors should have the same access to the funds. Other non-qualified plans include Simplified Employee Pension (SEP) accounts, Roth IRAs, and single-owner qualified plans.

Because IRAs do not enjoy federal lawsuit immunity as do ERISA-qualified plans, their statutory protection (or lack thereof) is determined by state law. As with other state exemptions (homestead, insurance, wages, etc.), state laws vary. For example, several states fully protect IRAs, but many others afford them no lawsuit protection. However, most states at least partially protect non-qualified plans. Their protection may be either for a statutory amount (i.e., $50,000) or for such amount as a court deems necessary for the debtor's support. There may be other limitations or restrictions under various state statutes. A further word of warning: some states may protect traditional IRAs, but not other IRA types such as Roth, SEP, and SIMPLE IRAs. This is usually due to a state legislator's failure to update exemption laws to account for these newer IRA types. Be aware of such loopholes and plan accordingly.

Some states protect only those accounts held in trust or custodianship, but do not protect distributions to a beneficiary. If a state's laws are silent on this point, then one must review relevant state court decisions. The good news concerning IRAs is they have considerable bankruptcy protection, which we'll discuss in the next section.

This uncertainty leads to one conclusion: IRAs and other non-qualified plans must be carefully reviewed by an asset protection or bankruptcy lawyer. One can't assume their plan is automatically protected.

What if an IRA is not protected by state law? If this is the case, we still have options. For example:

- If you are considering rolling an ERISA-governed pension into an IRA, think twice before doing so. You may lose considerable asset protection.
- If your pension was once qualified, but has already been rolled over into an IRA, one can usually roll it back into a qualified plan.
- You can always liquidate your IRA and then protect the proceeds, however if you do this before reaching age 59½, there is a 10% early withdrawal penalty.[107]

- Invest your IRA into a multi-member LLC or limited partnership that is managed by someone friendly to you. Even though the IRA may be seized by a creditor, the company's manager could then refuse to make distributions. The creditor thus finds himself in a stalemate, which often leads to a settlement more favorable to the debtor. A note of caution: when using an IRA to buy an interest in a company, one must make sure the company does not engage in prohibited transactions, make prohibited investments, or deal with disqualified persons.[108] Furthermore, one should not take a management fee from an LLC they manage, if their IRA owns the LLC. Doing such might be viewed as taking an early distribution from the IRA.
- For strongest protection, invest your IRA into an offshore LLC that is managed by an offshore individual. This individual would not be subject to a U.S. court order to make distributions from the LLC, and thus it may even be a single member LLC if need be (although a multi-member LLC is preferable, if possible).
- Move to a state that protects IRAs. Although a drastic measure, this certainly provides protection.
- If annuities are protected in your state, consider investing your IRA in an annuity. Don't try this without the help of a professional. Note that IRAs are forbidden from investing in life insurance.[109]

Bankruptcy Exemptions/Pre-Bankruptcy Planning

Up to this point, we've mostly discussed exemption planning in a non-bankruptcy context. However, when one files for bankruptcy the exemption rules change considerably.[110] Therefore, when doing exemption planning one must consider the likelihood of an individual declaring bankruptcy in the future. Even if bankruptcy is unlikely, one must plan for the contingency that it could happen. For example, an individual could be involuntarily petitioned into bankruptcy (Chapters 7 or 11) by three or more creditors if their aggregate claim exceeds $12,300, or even by one creditor if the debtor has fewer than 12 creditors, and the creditor filing the petition has claims exceeding, in the aggregate, $12,300.[111]

The law of the state where one resides determines whether one may use state exemptions only, or whether one may choose between state or federal exemptions. If a state allows one to choose, then one may choose one set of exemptions but not both. The federal exemption amount may be doubled for a married couple, although this may or may not be the case with state exemptions. Note that moving to a more exemption-friendly state before one files bankruptcy only works if the move is made at least 730 days (about 2 years) before filing.[112]

If state exemptions are chosen, there may be federal restrictions to those exemptions. The most notable is the homestead restriction. Federal law states that a homestead exemption may not exceed $125,000 for any home purchased within 1215 days (3.3 years) of filing bankruptcy.[113]

Some state exemption laws may also be augmented by federal exemptions under certain circumstances. These exemptions fall into three categories:

- Family exemptions. In many states, married couples qualify for family exemptions, which allow them to keep more unsecured property.
- Head of household exemptions. This applies to single individuals who supply 50 percent or more support for at least one other individual living in their home. A person who qualifies for this exemption may claim more exempt property than a single person with no dependents.
- Specific property exemptions. These exemptions apply to specific types of property (and the exemption may be unlimited or to a specified dollar amount), and are available regardless of whether one is single, married, or the head of a household.

Regardless of a state's exemption laws, retirement accounts are protected in bankruptcy, in the aggregate, up to $1 million.[114] A court may increase this exemption amount "if the interests of justice so require".[115] Unfortunately, this protection does not extend to SIMPLE or SEP IRAs.[116] However, amounts rolled over from other retirement accounts into an IRA generally enjoy unlimited bankruptcy protection, and are not considered when calculating an IRA's value for purposes of determining whether the $1 million cap is exceeded.[117]

Of final note are the exemptions afforded education individual retirement accounts.[118] The most common type of education individual retirement account are the "section 529 plans", or college tuition savings plans administered by each of the 50 states. Any funds placed into such an account at least 720 days before filing bankruptcy is fully exempt, and any funds placed in such an account at least 365 days before filing bankruptcy but less than 720 days from the filing are protected to $5,000.[119]

Applicability of State Exemption Laws vs. a Federal Agency

Although we've seen the usefulness of state exemption laws in regards to bankruptcy and state-adjudicated claims, the landscape changes somewhat when a federal agency is the creditor. To what extent do state exemption laws protect against an arm of the U.S. government?

The answer lies in the Federal Debt Collection Procedure Act (FDCPA)[120], which specifies that "An individual debtor may, in an action or proceeding under this chapter, elect to exempt… any property that is exempt under… State or local law… as long as these exemptions are not used in conjunction with [the bankruptcy code exemptions.]"[121]

As to whether the FDCPA applies in any particular federal case, the FDCPA states that "Except as provided in subsection (b), the chapter provides the exclusive civil procedures for the United States — (1) to recover a judgment on a debt…"[122] Furthermore, a judgment debt in a civil proceeding is clearly a debt, since the FDCPA defines "debt" to include a "…fine, assessment, penalty, restitution, [or] damages…"[123]

Although being able to use state exemptions to protect against creditor claims in federal court is good news, there are of course exceptions to this general rule. These exceptions are found in FDCPA §3001(b):

> "**(b) Limitation.** — To the extent that another Federal law specifies procedures for recovering on a claim or a judgment for a debt arising under such law, those procedures shall apply to such claim or judgment to the extent those procedures are inconsistent with this chapter."

Furthermore, we must consider FDCPA §3003(b):

> "**(b) Effect on Rights of the United States.** — This chapter shall not be construed to curtail or limit the right of the United States under any other Federal law or any State law —
>
> (1) to collect taxes or to collect any other amount collectible in the same manner as a tax;
>
> (2) to collect any fine, penalty, assessment, restitution, or forfeiture arising in a criminal case;
>
> (3) to appoint or seek the appointment of a receiver; or
>
> (4) to enforce a security agreement."

In light of the above statutes and also relevant case law,[124] the FDCPA (which allows state exemption laws to take effect) governs collection procedures in regards to a judgment in favor of a federal agency. However, if the FDCPA conflicts with another Federal law, or the debt arises from a tax or criminal penalty, then one cannot count on state exemptions for protection.

On a tangent note, we must examine the impact of the FDCPA on State and Federal statutes of limitation. Although §3014 allows for exemptions, nothing in the Act allows for any statute of limitations to take effect. In fact, collections under the FDCPA have no statute of limitations whatsoever. This point is confirmed in *Pierce v. U.S.,*[125] wherein the court states, "State procedures should not be read into the FDCPA where the Act is intentionally silent. The absence of a time limitation for execution against property in the FDCPA was intended to provide 'for execution procedures to track the indefinite life of a judgment in favor of the United States.' *United States v. Pierce*, 231 B.R. 890, 893, 1998 U.S. Dist. (E.D.N.C. 1998). For the same reasons provided in the 19 October 1998 order, 'we must and should assume that Congress was aware that a federal judgment is unrestricted in duration.'"

Overall Effectiveness of Exemption Planning

Despite the caveats we've discussed, exemption planning is effective if it's done right. Despite losing a huge wrongful death suit, O.J. Simpson succeeded in keeping his retirement funds protected by his NFL ERISA[126] — governed pension plan. Furthermore, his Florida homestead is 100% protected against his creditors. This is just one of many instances where exemption planning provided rock-solid asset protection. However, although some exemption planning will protect against some creditors most of the time, and other creditors all of the time, no exemption planning, not even ERISA-governed retirement plans will protect against all creditors all of the time. For example, if O.J. Simpson was criminally convicted in federal court, our foregoing analysis shows that his exemption planning would not have worked. Furthermore, we must remember that exemption planning may be vulnerable to attachment by a state or federal government agency.

What this all boils down to is that exemption planning is *not* a do-it-yourself project, and also the planning is very specific to the state where one resides. Consequently, the most effective planning typically involves an asset protection planner *and* a local attorney familiar with the state's exemption laws, who work together to implement a plan.

Three Practice Concerns with Exemption Planning

As we can see from our discussion thus far, there are some particular problems with exemption and pre-bankruptcy planning. These concerns mostly arise in three areas. The first area involves the shifting of exemption rules from a non-bankruptcy to a bankruptcy scenario. The second problem area involves a shift in rules, in both non-bankruptcy and bankruptcy scenarios, when the individual moves to another state. The third problem area involves creditors, such as the IRS or another state or federal agency, which may be able to ignore exemption laws. Because it's impossible to say for sure that an individual will never declare bankruptcy, or that they'll always live in one state, or that they'll never have IRS or other government agency problems, with the exception of a few asset classes (such as ERISA-governed plans that will not enter payout status for many years) we must structure an exemption plan so as to be flexible if changes need to be made due to an individual's change in circumstances.

An example of flexible planning is avoiding placing large amounts of cash into an IRA, even if the current state of an individual's residence fully protects IRAs, unless that individual is willing to move the IRA offshore if such a need arises. Alternatively, if an individual is older than 59½, we can use IRAs in an IRA-protected state so long as the individual is willing to liquidate the IRA if need be (an IRA that's liquidated before its owner is 59½ is subject to a 10% early withdrawal penalty.)[127] There are many, many other examples of how we might "paint ourselves into a corner" with an individual's exemption plan if we are not forward-thinking. Examining every contingency in every scenario would be a multi-volume treatise by itself, which is exactly why plans should usually be made as flexible as possible.

CHAPTER SEVEN

Co-Ownership Planning

What is Co-Ownership Planning?

Co-ownership planning is defined as the concurrent ownership of property by two or more people. The most common co-ownerships involve assets owned by a husband and wife. When we refer to co-ownerships, we do not usually mean the ownership of business entities by multiple individuals (unless an undivided interest is held jointly or as tenants by the entirety), nor are we referring to multiple beneficial interests in a trust.

There are four types of co-ownership planning, namely:

- Tenancy in common (TIC).
- Joint tenants with right of survivorship (JTWROS); JTWROS is often referred to simply as "joint tenants" ownership.
- Tenants by the entirety (TBE).
- Community property.

Of the above, only TBE ownership provides any meaningful asset protection, and the other ownership types may actually increase the chance of losing property to creditors. We examine each type of ownership below.

Tenancy in Common (TIC)

When property is held as tenancy in common (TIC), it means each person holds a distinct and separate share of the property. Shares need not be equal. For example, three people may own real estate, wherein two people each could own 25% of the property and one owns 50%. If the property is sold, each person would receive their respective share of the proceeds. Unless a contract says otherwise, each person has the right to transfer their interest without the consent of the other owners. TIC is the default type of concurrent ownership, and does not include right of survivorship (we define right of survivorship in the next section.)

TIC does not provide any meaningful asset protection. If one of the TIC owners has a judgment creditor, that creditor can either force the sale of property through foreclosure, or (if feasible) they can partition the property and then seize the debtor-owner's partition in its entirety. If a foreclosure sale is held, the creditor can only receive a portion of the foreclosure proceeds that are proportionate to the debtor's share in the property. However, the non-debtor owners still lose the property, although they do receive the remainder of foreclosure proceeds. One could say that TIC actually makes things worse from an asset protection perspective, because the more owners there are, the more likely it is that one of them will encounter creditor problems, which could cause everyone to lose the property. We therefore *never* recommend TIC as a means to protect assets.

Joint Tenants with Right of Survivorship (JTWROS)

Joint tenants with right of survivorship (JTWROS) is akin to TIC ownership, except when one owner dies, their interest does not pass to his or her heirs. Instead, the other owners automatically receive the deceased individual's interest (this is called "right of survivorship".) JTWROS thus avoids probate, which is the often costly and time-consuming court-supervised process of passing wealth to one's heirs. JTWROS is also different from TIC in the following ways:

- Each person must acquire title to the property at the same time.
- Each person must have an equal share in the property.
- Each person must hold the same type of title.
- Each person must have access to the property in its entirety (for example, a joint bank account's funds must be completely accessible to each joint owner.)

Although JTWROS may offer estate planning benefits, a creditor can attach, foreclose on, or partition a JTWROS interest just like it can with tenancy in common property. In the case of joint bank or trading accounts, either owner may access all of the account. Therefore, a creditor may do likewise, meaning a creditor of *either* joint owner may seize *all* of the account's funds in order to satisfy their debt. Consequently, although there may be valid reasons for wanting a joint account, there is always a safer alternative. For example, suppose an elderly widow wanted a joint bank account with her son, so that if anything happened to her the son could use the money to take care of her, or he could inherit the money sans probate if she died. The downside is that this account could be seized by either the son's or mother's creditors. A better solution would be for the mother to give her son a durable power of attorney, which would allow him to access the account if she was incapacitated. A living trust could also be created to quickly and safely pass the account's ownership to the son when the mother dies. Neither of these tools would expose the account to the son's creditors during the mother's lifetime. If desired, the trust could be structured so that even after the mother's death, trust assets would remain out of the reach of her son's creditors.

JTWROS may have other unintended and undesirable side-effects. For example, let's say a man married and had three children. He then divorced and remarried. Subsequently, he titled his home and liquid assets in his and his spouse's names as JTWROS. When the husband dies, do the children inherit the home or liquid assets? Unfortunately, the answer is no. All JTWROS property passes to the new spouse and the children get nothing. Because of the often unintended consequences of JTWROS, we almost always recommend alternatives.

Tenancy By the Entirety (TBE)

Of all co-ownership types, tenancy by the entirety (TBE) is the only one that may provide meaningful asset protection. Tenancy by the entirety is a special type of co-ownership that is only available to a husband and wife. TBE ownership must also meet the requirements of JTWROS in order to be valid, and if a couple divorces, then ownership will be held as TIC or JTWROS rather than tenants by the entirety. TBE offers right of survivorship benefits (like JTWROS), but it may also protect the asset in certain states, as along as only one spouse comes under creditor attack. That's because, in most states that allow TBE, the property may not be transferred or otherwise alienated without the other spouse's consent. Furthermore, neither spouse owns a fractional share in the property. Rather, each spouse claims an entire ownership interest in the property, but such ownership is subject to the other spouse maintaining their property rights as well. Because the ownership interest is not divisible, and may not be transferred without the other spouse's consent, most TBE states do not allow a creditor of one spouse to attach any TBE property without the consent of both spouses.

Unfortunately, TBE ownership is not available in all states, and in states where it is available, it may not be allowed for all property types. Table 7.1, below, differentiates between states that allow TBE, states that allow TBE for real property only, states that prohibit TBE (either by case or statutory law), or states where it is unclear whether TBE ownership is allowed. Even with the breakdown of TBE ownership into these four categories, one should still consult statutory and case law for his or her particular state, as there are further subcategories of TBE ownership types. For example, a few states restrict TBE ownership to primary residences only. Furthermore, only Alaska, Hawaii, Tennessee, and Vermont specifically allow rental real estate to be held as TBE.[128]

TABLE 7.1: TBE Ownership Types Among the 50 States

TBE Allowed for Property Types Besides Real Estate[129]	**TBE Allowed for Real Property Only**	**TBE Not Allowed**[130]	**Possible TBE States (Statute and Case Law are Unclear)**
Alaska, Arkansas, Delaware, District of Columbia, Florida, Hawaii, Maryland, Massachusetts, Mississippi, Missouri, New Jersey, Oklahoma, Pennsylvania, Rhode Island, Vermont, Virginia, Tennessee, Wyoming	Illinois, Indiana, Kentucky, Michigan, New York, North Carolina, Oregon	California, Connecticut, Iowa, Maine, Minnesota, Nevada, New Hampshire, New Mexico, North Dakota, South Dakota, Washington, West Virginia, and Wisconsin	Alabama, Arizona, Colorado, Georgia, Idaho, Illinois, Kansas, Louisiana, Nebraska, South Carolina, Texas, and Utah

Even if TBE is allowed, the case and statutory law of a few states will not protect TBE property from creditors. Therefore, these laws and cases must be checked before relying on TBE ownership for asset protection. Another problem with tenancy by the entirety is the fact that TBE's asset protection has somewhat eroded over the years. For example, a 2002 U.S. Supreme Court case allowed an IRS tax lien to ignore the protection normally afforded TBE ownership.[131] Consequently, it is now standard operating procedure for the IRS to seize one-half of a TBE property's sale proceeds (up to the amount of the tax lien) if a tax lien has attached to either spouse. A state-specific example of TBE failing to protect an asset is found in a 1993 Massachusetts case, *Coraccio v. Lowell Five Cents Savings Bank*. In *Corracio*, the court ruled that under Massachusetts law, a husband had a right to unilaterally manage TBE property, which in this case was the debtor's primary residence. This right gave him the power to transfer or encumber the property without the wife's consent, whereas the wife only had a right of survivorship. The court ruled that, although the husband could not alienate her right of survivorship, but he could alienate the property itself. Conversely, the wife did not have the right to alienate the property without her husband's consent. The special rights afforded the husband were due to ancient TBE laws that were not properly updated as women were given equal rights in our society. Subsequently, when the husband applied for a 2nd mortgage on their home and failed to make payments, the bank that held the mortgage was allowed to foreclose on the property. Although most states that specifically allow TBE ownership do not have adverse case law like the *Corracio* case, one law professor notes that "only Massachusetts, Michigan, and North Carolina have brought into modern times the tenancy's ancient husband-oriented form."[134]

In contrast to the above, there are cases where TBE ownership has successfully shielded assets.[135] Nonetheless, the foregoing leads us to conclude that TBE cannot be relied upon as an impenetrable creditor defense. On the upside, because it's very easy to title assets as tenants by the entirety between a husband and wife (in states that allow such), TBE is a great way to add an extra layer of protection.

For example, in a state that allows TBE, it may be a good idea to title ownership of business entities as TBE. In one Florida case, doing this protected a couple's TBE interest in a limited partnership from the husband's creditors.[136] Nonetheless, merely saying an asset is held as TBE is not sufficient by itself. One must also meet the criteria described in this chapter's section on joint tenants with right of survivorship, in addition to both owners being husband and wife.

Community Property

There are ten community property states: Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. A community property state is a state where all marital property (property of the "community") is automatically deemed to be owned 50/50 by each spouse, even if it is only titled in one spouse's name. Marital property is defined as any property acquired during the marriage. A boat one spouse acquired before marriage, for example, will not be considered community property, unless the boat is subsequently titled in both spouse's names. At the same time, it is easy for one spouse's pre-marital non-titled property, especially cash, to be commingled with the community and thus be considered community property. An inheritance acquired by one spouse during marriage may or may not be considered community property, depending on state law.

A married couple may separately own assets in a community property state via a *transmutation agreement*. A transmutation agreement is a type of post-nuptial agreement wherein each spouse agrees to keep their own property separate and outside the community estate. A well-drafted transmutation agreement thus supersedes community property law. When drafting a transmutation agreement, each spouse should retain separate counsel and have full disclosure of the agreement's ramifications in order to prevent the agreement from later being challenged. If one spouse is particularly vulnerable to creditor threats, a transmutation agreement allows the less vulnerable spouse to separately hold assets, which may provide asset protection if done before the more vulnerable spouse has creditor problems. There are some potential downsides to this solution, however, which we discuss in the next section.

The community property law of some states actually increases one's likelihood of losing marital assets to creditors. As we discussed in the *McIntyre v. USA*[137] case in Chapter 6, some states (such as California in the *McIntyre* case) allow a creditor to reach all community assets for the debts of either spouse. In contrast, a few states' community property laws actually provide limited asset protection. For example, Arizona allows a debt acquired by either spouse prior to marriage to be satisfied from community property, but only to the extent of the value of that spouse's contribution to the community that would have been such spouse's separate property if he or she were single.[138] In contrast, an unsecured debt acquired during marriage may not be satisfied from community property.[139] Nevada allows a spouse's separate debt to be satisfied from community property, but only if the wife acquires debt because the husband didn't provide for her necessities. Such a debt can then be satisfied from any community property, or from the husband's separate property.[140] In Texas, only tort debts (but not contract debts) may be satisfied from community property, but if the debt arises from a tort, then it may be satisfied from any and all community property.[141] The same can be said for tort debts in Washington, except they may only be satisfied from the debtor's half of community property.[142]

On the other hand, California, Louisiana, Idaho, New Mexico, and Wisconsin[143] allow a separate debt acquired by either spouse during marriage to be satisfied out of any community property.

Titling Assets in the Name of a Less-Vulnerable Spouse

If one spouse's activities expose him or her to a high risk of lawsuits or other creditor threats, titling assets into the other spouse's name may be a good idea. However, there are exceptions to this rule. For example:

- As we discussed earlier in this chapter, titling assets into the other spouse's name, without a transmutation agreement, isn't effective in community property states.

- In non-community property states, or in a community property state with a transmutation agreement, titling the bulk of marital assets in a single spouse's name can cause obvious problems in the event of divorce. Why should the spouse with most of the assets give those assets back to the spouse who willingly gave up those assets in the first place? It's not wise to leave it up to a divorce court to answer this question!
- Transferring assets to a spouse is almost always done as a gift, and as this book's chapter on fraudulent transfers explains, gifts are very susceptible to fraudulent transfer rulings. An apparent workaround for this dilemma would be for one spouse to actually sell assets to the other instead of making gifts. However, doing this would probably not avoid a fraudulent transfer ruling for several reasons. First, such a transfer is to an insider. Second, it will be difficult to justify why one spouse sold something to another spouse for any reason other than asset protection. If a court determines the sale was done to protect assets, they may determine such as *prima facie* evidence of intent to defraud creditors, even if creditor threat was not imminent when the transfer was made.[144]

How Much Should One Rely on Co-Ownership Laws for Asset Protection?

Co-ownership planning has its pitfalls and thus should never be the exclusive line of defense against creditors. First, the statutory protection afforded co-ownerships has been steadily eroded by the courts. We can expect parts of this protection, at least, to continue to erode in the future. Furthermore, a client may move from a state that protects assets through co-ownership to one that does not. For example, a client can move from a state that allows TBE ownership to a state that forbids it, or to a state that allows it but does not allow TBE ownership to protect assets. Third, like with exemption planning there are always caveats to when a certain type of co-ownership will protect assets. Because such broad, "blanket" protection is unavailable through co-ownership planning, assets should, when possible, always be protected by additional measures, such as equity stripping, placing assets offshore, or placing assets in a limited partnership or LLC. The next several chapters will introduce these more effective planning tools.

CHAPTER EIGHT

The Corporation and Limited Liability Concepts

The Corporation: A Brief Historical Primer

Chief Justice John Marshall defined a corporation in the 1819 case *Dartmouth College v. Woodward* when he said “A corporation is an artificial being, invisible, intangible, and existing only in the contemplation of the law… Among the most important [of its qualities] are immortality, and if the expression be allowed, individuality; properties by which a perpetual succession of many persons may be considered the same, and may act as a single individual...”[145] Using this definition, we can consider the oldest known corporation to be the Benedictine Order of the Catholic Church, which was founded in 529. Although originally used as government or religious entities[146], corporations were eventually used for business. Probably the oldest surviving business corporation is Stora Kopperberg, founded in 1288, and known today as StoraEnso.[147] Business corporations historically did not have many of the features that are found in them today. They were typically granted by government charter (the first chartered corporation being the East Indian Trading Company, which was chartered by Queen Elizabeth I in 1601). Early corporations of this type, which formed the basis for the modern corporation, were supervised closely by the government and could have their charter revoked if they performed poorly or exceeded the bounds set for them. The earliest corporations did not have limited liability, and only rarely were of perpetual duration. In North America, only seven corporations existed during the entire colonial period.[148] The various U.S. states allowed corporations to have limited liability much later than Europe; most U.S. corporations did not enjoy such until the 1830's.[149] Perpetual duration was rare in the U.S. until after the civil war (before this, most corporations lasted 30 years or less).[150] Eventually, as corporations grew in popularity, the states passed and revised legislation throughout the 19th century that allowed the general citizenry to form corporations, and in the landmark case *Santa Clara v. Pacific Railroad*, the U.S. Supreme Court granted corporations all the rights of a U.S. citizen as guaranteed by the 14th amendment.[151] Today, the corporation stands as the first business organization to enjoy limited liability. However, with the exception of publicly traded companies, in most situations its usefulness has been eclipsed by the more flexible and less cumbersome limited liability company. As an asset protection tool, the corporation remains effective against shielding its owners from corporate debts, however a judgment creditor may seize a debtor's corporate stock, and therefore small corporations with only a few owners are vulnerable to outside liability threats (wherein a stockholder has liability for a debt not related to the corporation's activities). We'll explore the limited liability characteristics of corporations in detail shortly.

Features of U.S.-Based Corporations

In the U.S. today, a corporation is formed by filing articles of incorporation in any one of the 50 states. State filing fees vary, but are usually a few hundred dollars or less. Domestic business corporations all have the following attributes:

- They have a three-tiered management structure: stockholders elect a board of directors, who make strategic decisions and who in turn hire corporate officers (the president, secretary, and treasurer), who manage the corporation's day-to-day affairs.
- Generally speaking (with a few exceptions), corporate stockholders are not liable for corporate debts.
- Corporations may exist perpetually.
- Corporations are considered a legal "person" and may engage in any lawful business, although some services, such as banking, insurance, or professional services, are reserved to special types of corporations, or to other special business entities. As a person legally separate from its owners, a corporation may hold assets, sue or be sued, hire agents, and otherwise legally do anything a normal person may do. However, a business corporation should only engage in activities that have a demonstrable business purpose, in order to ensure its limited liability remains intact.

- Corporate stock typically may be sold, assigned, or otherwise transferred by a stockholder without the consent of the board of directors or other stockholders.
- A drawback of corporations is they must honor certain "corporate formalities" in order to ensure their limited liability. Such corporate formalities include annual meetings and keeping a record of corporate resolutions and minutes. General accounting procedure is also mandatory, and corporate assets may not be used for the personal needs of its stockholders, directors, or employees.
- Corporations may be taxed one of two ways: in accordance with subtitle A, Chapter 1, subchapter C of the Internal Revenue Code[152] (a "C" corporation), or in accordance with subtitle A, Chapter 1, subchapter S of the Code (an "S" corporation). C corporations pay taxes as a separate entity, and then the stockholders are taxed again (this is called "double-taxation") when they receive corporate profit distributions (called "dividends"). S corporations do not pay tax as a separate entity. Rather, its owners pay taxes on their share of the corporation's profits or losses.

The Corporation as a Business and Asset Protection Tool

As a business and asset protection tool, corporations are generally inferior to the LLC for the following reasons:

- Corporations are often liable for state franchise or other taxes that LLCs in many states avoid. For example, at the time of this writing there is a 6.25% flat tax levied on Missouri corporate income, plus an annual tax of 0.05% on the value of the corporation's stock, whereas Missouri LLCs pay no such tax.[153]
- LLCs typically have a more informal one or two-tiered management structure (although they may have a three-tiered management structure if such is desired) with no statutory requirement to hold officer meetings or to keep corporate minutes (although doing so may still be a good idea). Therefore LLCs are often easier to operate. Because of the lack of a requirement to follow such "corporate formalities", among other things, there are fewer reasons for piercing the veil of an LLC.[154]
- Corporations do not benefit from the "charging order protection" that LLCs and limited partnerships enjoy. Essentially, charging order protection statutorily limits a creditor's remedy, so that they may not generally seize a debtor-owner's interest in the company; neither may they reach assets inside the company or gain control of the company. Conversely, corporate stock may be seized by a creditor. If the creditor obtains a majority in interest (51% or more) of voting stock, s/he may

vote to liquidate the corporation and thus attach corporate assets upon liquidation. Not good! For more information on charging order protection, read this book's chapter on limited partnerships.

- An LLC may be structured so as to be taxed as an entity disregarded from its owner (also known as a "disregarded entity"), a partnership, an S corporation, or a C corporation. Corporations on the other hand may not choose partnership or disregarded entity tax treatment.
- Another danger is that corporations used primarily to hold passive investments or other dividend or interest-bearing 'passive income' assets create serious 'holding' corporation tax problems. The IRS heavily taxes the 'passive' investment income of holding corporations. LLCs and other entities generally have no such problem.
- Another problem with corporations is if you contribute an appreciated asset to it, and at a later time wish to take the asset back out, you will have to treat the appreciated amount as taxable gain (the appreciated amount is typically the fair market value of the asset when it's redistributed to you, minus the fair market value of the asset when you first obtained it.) Redistributing partnership or LLC assets (so long as the LLC has not elected corporate tax treatment), however, will not usually trigger a tax as long as you haven't transferred your LLC interest to someone else in the meantime.

Nonetheless, despite the foregoing, there are at least two instances where a corporation is preferable to an LLC or limited partnership.

- Unlike an LLC or limited partnership's ownership interest, corporate stock is freely transferable without needing the consent of the other owners. This makes the corporation the entity of choice if it is going to be publicly traded.
- A few states, such as California, reserve certain business activities to corporations. For example, at the time of this writing only professional corporations may be formed in California if a company is to render professional services, such as medical or legal services.[155] Other business ventures, such as real estate transactions that require a license, may be performed in California by a corporation but not an LLC or limited partnership.

Piercing the Veil to Disregard the Limited Liability Shield

Many years ago, attorneys began successfully arguing that the protective "veil" of a corporation should be set aside in certain circumstances. Essentially, this means the limited liability shield would be disregarded, so that company owners may be held directly liable for company debts. There are four primary ways in which a corporation can be abused. A helpful overview of three of these causes is discussed in *Garcia v. Coffman*[156]. In this case, the three criteria for piercing the corporate veil are identified as Instrumentality or Domination, Improper Purpose, and Proximate Cause. Another case, *Norris Chemical Company v. Ingram*,[157] discusses under capitalization as a reason for disregarding the corporate veil. Note that there is some variance between states as to when a limited liability veil may be pierced. Also, LLCs and limited partnerships have slightly different criteria governing when they may be pierced (which criteria is discussed in this book's chapters on limited partnerships and LLCs, respectively). Therefore, this section is only a general overview of veil-piercing. Further reference to statutory and case law as applicable to a particular situation is strongly recommended. With the foregoing in mind, let's examine the general criteria under which a limited liability veil may be pierced.

Instrumentality or Domination

Instrumentality (also known as domination) is commonly known as the 'alter ego' theory. The argument goes that if the limited liability entity is treated as an extension of a single person, to the extent that the entity and individual's activities are practically indistinguishable one from another, then the entity and individual should be treated as a single individual with no liability protection. In other words, the entity is "dominated" or used as an instrument for a sole individual's purposes. Failure to observe corporate formalities (as mentioned earlier in this chapter) may or may not be a mitigating factor in demonstrating the domination of a corporation.[158]

One nice thing about the limited liability company is the laws of almost all states allow them to have only one member. Furthermore, multi-member LLCs follow more of a partnership management structure (which is more informal and, in the case of a limited partnership, may be controlled by one general partner) than that of a corporation. In other words, they are *designed* by law to be (in many ways) 'dominated' by a single person. The instrumentality or domination theory is thus an ineffective argument for piercing the veil of an LLC.[159] However, that doesn't mean an LLC member should ignore the dangers of a possible alter ego ruling. To be safe, all limited liability entities should still be treated as separate from their owner(s). They should have separate bank accounts, and the business's real estate and vehicles should be titled in the entity's name. Furthermore, company bank accounts shouldn't be used to 'commingle' business and personal funds. In other words, using a company's bank account to buy groceries for oneself, or to pay a personal car or house payment is a big 'don't'.

Improper Purpose

Defining improper purpose is simple: if a limited liability entity is used to commit a fraud, injustice, or wrong, it shouldn't protect its owners from liability. In other words, don't use a limited liability entity to defraud or otherwise take advantage of someone, and then expect the entity to protect you. It is important to note that, while some states consider fraud or a similar injustice as only one of several reasons for piercing the corporate veil, some states require the presence of fraud as a prerequisite to veil-piercing. For example, a Delaware court found that "Piercing the corporate veil under the alter ego theory requires that the corporate structure cause fraud or similar injustice. Effectively, the corporation must be a sham and exist for no other purpose than as a vehicle for fraud… [m]ere dominion and control… [by itself] will not support alter ego liability." [160] A Tennessee court likewise concluded, "Tennessee law still requires an element of fraud in order to pierce a corporate veil."[161]

Proximate Cause

Proximate cause simply means there must be a reason to hold an entity or its owners liable for a debt. If there is no proximate cause, then the domination, undercapitalization, or improper purpose theories are inapplicable. There must be some established debt, tort, or contract dispute that the entity is a direct party to. This why a "safe" entity (one that never generates liability, such as an LLC that merely holds investments) has a somewhat reduced risk of having its veil pierced. At the same time, the entity may be reverse-pierced for the improper activities of its owner, and is thus not completely free of the veil-piercing threat. Reverse piercing is defined a little later on in this chapter.

Inadequate Capitalization

The inadequate capitalization theory states that a corporation must have adequate funds to pay its debts in the normal course of business. If it is insufficiently capitalized to pay for such, then its veil may be pierced. Inadequate capitalization does not, however, involve debts that would not arise in the normal course of business, i.e. a lawsuit that or threat of a lawsuit that was neither anticipated nor existing at the time of the company's formation.[162] Furthermore, most states only consider whether the corporation was adequately capitalized during its inception. If a corporation is adequately capitalized upon its creation, but encounters hard times and as a result later becomes unable to pay its debts, such insolvency is generally not adequate reason for piercing its veil.[163]

Reverse Piercing

The opposite of piercing the veil, of course, is to reverse-pierce the veil. This is where a company's assets are made available to a creditor of a shareholder. This is one of two primary means for such a creditor to seize corporate assets; the other means is to seize, if possible, a majority of a corporation's voting stock from a debtor-shareholder, and then vote to liquidate the corporation. Reverse piercing is discussed in detail in the chapter of this book entitled "Asset Protection a Judge Will Respect."

Holding Corporate Officers and/or Directors Liable for Company-Related Torts

The criteria governing when corporate officers may be held directly liable for torts committed in the course of a company's business varies widely from state to state. For example, Delaware corporate law states:

> "No suit shall be brought against any officer, director or stockholder for any debt of a corporation of which such person is an officer, director or stockholder, until judgment be obtained therefor against the corporation and execution thereon returned unsatisfied."[164]

Compare this to Nevada law, which allows a suit directly against a corporate officer or director if the corporation is their alter ego, even if a judgment against the corporation has not yet been awarded:

> "Except as otherwise provided by specific statute, no stockholder, director or officer of a corporation is individually liable for a debt or liability of the corporation, unless the stockholder, director or officer acts as the alter ego of the corporation."[165]

Now compare the previous two statutes to California law, which allows a claim to proceed against a corporate director, if the plaintiff alleges the director acted in bad faith (however the director will only be liable for corporate debts if he did indeed act in bad faith as a director.)[166] Unfortunately, except in the case of Delaware, in almost all states it is possible for a plaintiff to, at least initially, bring suit against a corporate director or officer as well as the corporation itself. This is an extremely common litigation tactic, and is used as a means to pressure the corporation's principals into a settlement. After all, it's one thing to drag business activities through the discovery process, and quite another to subject one's personal conduct to discovery, which depending on the facts of the case may be quite embarrassing. Such a tactic is also used against the managing members or general (managing) partners of an LLC or limited partnership, respectively. Furthermore, no state's corporate laws will protect a company's manager, officer, or director if the person is involved in a tort such as fraud or sexual harassment. The fact of the matter is, no matter where the manager or the corporation is domiciled or does business, there is always at least some exposure to liability. Therefore, risk of such liability should be dealt with by doing one or (preferably more) of the following:

- Buying director's liability insurance.
- Implementing an asset protection program to protect the director's personal assets.
- If possible, have another person, or at least an LLC or other limited liability entity manage the company's affairs as much as possible (this will shield directors and managers from some but not all claims.)

Where Should I Form My Limited Liability Entity? (Considering Choice-of-Law and Other Issues)

A few jurisdictions, especially Nevada, Wyoming, and Delaware, are heavily marketed as offering superior asset protection. Is there any substance behind the hype? The answer is only a little, and for the most part no.

Forming a corporation or LLC in the state of Nevada (which is notorious as the state of choice in which to domicile egregiously bad asset protection plans) may even raise a red flag that could weaken the effectiveness of a plan, unless of course the entity actually conducted business there. An example of this notoriety can be found in a report by a senior IRS director (small business division) wherein he states:

> "…non-compliant taxpayers, including non-filers, fraudulent taxpayers, abusive promoters and under-reporters, have taken advantage of certain state laws, particularly in Nevada. Nevada has laws that may be used to help hide the identity of the non-compliant taxpayers; these laws are perceived by some taxpayers as available to facilitate taxpayer non-cooperation with the IRS; and non-compliant taxpayers may take advantage of an established industry for forming and servicing corporate entities. …The IRS has authorized several investigations … into promoters of Nevada corporations and resident agents. These investigations have revealed widespread abuse, as well as problems in curtailing that abuse. …our office, as a result of several promoter investigations has obtained client lists that are being used as a source for potential non-filer audits. An initial sampling of the client lists showed that anywhere from 50 to 90 percent of those listed are currently, or have been previously, non-compliant with Federal tax laws. …While the

> non-compliance rates found in the client samples of the promoters we have investigated (50 to 90 percent) are probably not the norm across all Nevada corporations, even if non-compliance is a fraction of those numbers the potential loss to the Treasury is still considerable. … we are contemplating mass audits of non-filers that would produce a list of non-filer and non-compliant participants. …the Service will consider "John Doe summonses" to resident agents. The summonses would be similar to the ones issued to credit card companies related to the use of offshore credit cards. Nevada resident agents and incorporation companies provide a legitimate service to a group of unknown "Does" whom the Service has reason to believe are using these valid services to abuse the tax system."

The foregoing alone ought to discourage a non-Nevada resident from using a Nevada corporation for asset protection. However, there is more to choosing the state one forms an entity in than the reputation of its entities. We should also address choice-of-laws concerns, which are especially important when choosing an entity's domicile as part of an asset protection plan.

Perhaps the greatest motivation for a client do asset protection is to protect their wealth from lawsuits. The source of most lawsuits to which asset protection planning is most relevant, of course, is an alleged tort of one kind or another. Contrary to the claims of various Nevada/Delaware/Wyoming incorporation promoters, in regards to such litigation the laws of an entity's domicile will likely not govern alter ego, reverse-piercing, and fraudulent transfer issues. Rather, the governing law will likely be determined according to a legal maxim known as "lex loci delicti", which means the "law of the place where the tort was committed". This doctrine has evolved somewhat over time, as was noted, among other cases, in *Higashi v. Brown*, which states:

> "Two tests have evolved over time to determine the proper choice of law in tort cases. The first is the "lex loci delicti" rule. Under this older rule, the law of the place of the wrong was uniformly applied to all tort cases. In later cases, however, the place of injury alone was not the controlling factor. *Armstrong v. Armstrong*, 441 P.2d 699, 701 (Alaska 1968). Alaska has now adopted a second test, "the most significant relationship" test, for conflicts of law questions. It requires the court to consider:
>
> (a) the place where the injury occurred, (b) the place where the conduct causing the injury occurred, (c) the domicil[e], residence, nationality, place of incorporation and place of business of the parties, and (d) the place where the relationship, if any, between the parties is centered. These contacts are to be evaluated according to their relative importance with respect to the particular issue."[169]

Some asset protection planners claim the law mandates the jurisdiction of an entity's domicile must govern matters of liability where managers or owners of the entity are concerned. The defendants in the case *Butler v. Adoption Media*, LLC made this exact argument, by stating that an Arizona LLC should be interpreted according to California rather than Arizona law (California being where the alleged tort occurred). However, the court in this case disagreed:

> "Defendants argue that Arizona law applies because the Beverly-Killea Limited Liability Company Act, Cal. Corp.Code § 17000, et seq., provides for the application of the law of the state of organization (here, Arizona) to issues of liability between an LLC and its management and officers as well as to issues concerning the organization of the LLC. Cal. Corp.Code § 17450(a) ("The laws of the state ... under which a foreign limited liability company is organized shall govern its organization and internal affairs and the liability and authority of its managers and members."). The court finds, however, that § 17450(a) simply codifies the internal affairs doctrine, as applied to LLCs. [FN1][170] In other words, § 17450(a) does not apply to disputes that include people or entities that are not part of the LLC."[171]

The internal affairs doctrine, in general, says that the state of domicile governs an entity's internal affairs between itself, its managers or directors, and its owners. However, in *Butler* the court ruled that this does *not* extend to disputes with 3rd parties (although it's certainly conceivable that other courts in other jurisdictions may rule otherwise). Therefore, of the four criteria listed in *Higashi* for determining which laws will govern a limited liability entity involved in tort litigation with a 3rd party plaintiff, the place of the entity's incorporation or organization is probably the *least* important determining factor. Finally, even a dispute involving only parties related to a particular entity does not guarantee the internal affairs doctrine will govern the case at hand, as was demonstrated in *Greenspun v. Lindley*, wherein the court found "in consequence of significant contacts with New York State, … this investment trust, although a Massachusetts business trust, was nonetheless so "present" in our State as perhaps to call for the application of New York law. In that sense we reject any automatic application of the so-called "internal affairs" choice-of-law rule…"[172]

The foregoing does not mean that the laws of a state where a limited liability entity is domiciled will never be used, if a case is tried in another jurisdiction. However, it does mean one should not count on the laws where there entity is domiciled to save the day in all circumstances.

In conclusion, the jurisdiction under which an entity is formed has a lot less to do with how its limited liability holds up than some asset protection promoters would have one believe. For this reason, if an entity is conducting intrastate business in one or only a few states, it should probably be formed in one of the states wherein it operates. However, an entity that is not conducting intrastate business in any given state (which would relieve it of the requirement of registering in a particular state, other than where it's formed) may want to consider which jurisdiction is best for tax, ease-of-operation, and financial privacy reasons. (Those wishing to form an entity for legal financial privacy purposes should read the section entitled "Anonymous LLCs" in the chapter in this book regarding limited liability companies.)

Asset-Protecting Corporate Stock

As mentioned earlier in this chapter, corporate stock is not in and of itself safe from a stockholder's creditors. Therefore, additional steps must be taken ensure the stock's safety. Your options include the following:

- **Married couples may transfer their corporate shares to the less vulnerable spouse, who would then own the stock and control the corporation.** This is very easy to do, but is probably not the best solution, since gifting is vulnerable to a fraudulent transfer ruling, and since doing so places you at greater risk of losing the corporation should you divorce your spouse. However, since one may make unlimited tax-free gifts to his or her spouse, at least this is a tax-neutral option.
- **Transfer the shares to an LLC or limited partnership.** If done before creditor threats materialize, this is an excellent strategy that has several advantages. First, a transfer to an LLC or limited partnership (which could be domiciled either in the U.S. or offshore), if done as a capital contribution, is a tax free event. Second, the ownership interest of a properly structured LLC or limited partnership may not be seized by a creditor. Third, in most instances you may act as manager of the LLC or LP, and thus retain control of your corporate stock while still protecting it. You may also remain a director or corporate officer of the corporation if you desire. There is one caveat to this approach, however: only an entity that is structured so as to be disregarded for tax purposes from its owner (which must be a natural person who is a U.S. citizen) may own the shares of an S corporation (any entity may hold a C corporation's stock). However, it is possible to structure even a multi-member LLC or LP so that it is taxed as a 'disregarded entity',[173] and the IRS has allowed such an entity to hold S corporation stock without endangering the corporation's subchapter S tax election.[174] Note that it is not possible to structure a family limited partnership (FLP) as a disregarded entity if one wishes to avail themselves of the estate tax reduction benefits of such an entity.

- **Transfer the corporate shares to an irrevocable trust set up for your children or other beneficiaries.** This tactic, of course, means in most states you could no longer receive the benefits of stock ownership (such as voting rights and cash dividends) in either a direct or indirect manner. If you continue to benefit, even indirectly, from stock ownership, then the trust would essentially be self-settled (a self-settled trust is a trust where the person who transfers assets to the trust continues to benefit from the assets). Self-settled trusts by law do not provide asset protection in 42 of the 50 states.
- **Title your shares as tenants by the entirety.** Tenancy by the entirety is a type of joint ownership, allowed in about half of the states, wherein a husband and wife may jointly own property. If one spouse dies, the other automatically becomes the sole and complete owner of the property (this is called 'right of survivorship'). Neither spouse can sell or otherwise transfer their interest in the property without the other's consent. In many states that allow this type of ownership, the property may be attached only when both spouses are subject to creditors. If you co-own your shares with your spouse in a state that allows tenancy by the entirety interests, then this strategy may give your stock ownership sufficient protection when only one spouse has creditors. However, tenancy by the entirety does not offer complete protection (it will not protect an asset from the IRS, for example)[175], and therefore an even better (and perhaps optimal) arrangement would be to transfer the stock to an LLC or limited partnership, and then hold the LLC or limited partnership's interest as tenants by the entirety.
- **Assess your shares**. If your shares are not fully paid or if the shares are assessable by the corporation, then a creditor who seizes your shares takes them subject to your obligation to pay the assessment. Obviously, a potential assessment by the corporation reduces the value of the shares to your creditor by the amount of the potential assessment. An 'assessment' can be a particularly effective 'poison pill,' and we frequently include 'assessment provisions' in corporate documents as an anti-creditor device.
- **Issue irrevocable proxies.** A proxy is an assignment of your right to vote your shares. For example, you may issue a proxy to a relative, etc. A creditor who seizes your shares cannot vote your shares because the voting powers have been irrevocably assigned to the proxy holder. This, too, will significantly lessen the stock's value to the creditor, since the creditor would gain no voting rights in the corporation (and therefore be unable to vote to liquidate the corporation, even if they seized 51% or more of its voting stock). If you are sued, you may exchange voting shares for non-voting shares, which will also be of less value to creditors.

- **Dilute your stock ownership.** If you own a controlling (>50%) interest in a corporation, dilute your ownership. If and when it becomes necessary, you can have the corporation sell additional shares to other family members or to family controlled entities (trusts, limited partnerships, etc.). This is an issuance of new stock rather than a transfer of stock, and as long as it's done within normal operating business parameters, such a strategy is not considered under fraudulent transfer law. A creditor who seizes a minority ownership interest in the corporation cannot, of course, control the corporation. As a minority stockholder, the creditor only has the right to vote his or her shares and await whatever dividends may be declared. It is sometimes wise to spread the stock ownership in a family owned corporation between family members so that no one family member owns more than 49% of the voting shares. The bylaws would empower the remaining 51% to control the corporation.

Using Corporations and other Entities for Financial Privacy

No asset protection plan should rely exclusively on privacy.[176] There are many ways that privacy can fail, which could include, among other things, a disgruntled ex-spouse spilling the beans, to carelessness in operating the business, to being forced to reveal one's connection to an entity in a post-debtor examination (or otherwise commit perjury, which the authors strongly discourage). Every asset protection plan needs a solid legal structure underneath that will survive creditor attack regardless of whether its privacy holds up or not.

However, as one of several layers of protection, financial privacy does have its benefits, such as avoiding the appearance of being a "deep pocket", which helps prevent litigation. Such privacy is often the primary benefit espoused in the many marketing promotions of Nevada corporations, and to a lesser extent, Wyoming and Delaware corporations. Most of these promotions say that a corporation may be set up with "nominee" officers to shield the identity of who actually controls the business. (This is great for the nominee officers, since they can now charge the client each year for their nominee services.) Furthermore, in most states the identity of shareholders is not a matter of public record. It is true that this strategy provides some financial privacy. At the same time, complete financial privacy is more difficult to obtain than one might think, and as a result many clients forego such privacy measures, and instead focus mainly on a solid asset protection structure. For example, if one is a signer on a corporate bank account, they are linked to the corporation (and although this does not signify complete control over or ownership of the corporation, it is a starting point for an investigator to unravel one's financial privacy program), and thus for complete privacy a nominee must be used for all banking purposes. Many individuals may not trust someone else to have exclusive control over their company's bank account. Furthermore, for complete privacy a corporate bank account may not receive any deposits from any account that could be linked to the client, nor could payments (other than cash withdrawals) be made to any account or to pay any expense that would link the bank account to the client. Using a corporation in this manner is possible, but it may be more difficult to do than one initially supposes.

Furthermore, an S corporation must file an income tax return annually (form 1120S), and reveal its stockholders to the IRS via schedule K-1. A creditor may be able to obtain these forms during the discovery process, or especially during a post-judgment debtor's examination, in order to link the client to the corporation. If the corporation is taxed as a C corporation, and the client takes any dividends from the corporation, then he will be linked to the corporation when filing his or her annual 1040 return (schedule B), and a creditor may be able to obtain these returns in the same manner as they would with an S corporation.

An LLC formed in certain jurisdictions may in some instances reduce the requirements for obtaining financial privacy. Such LLCs are called "anonymous LLCs" because the state never asks who its members or managers are.[177] The more popular anonymous LLC states include New Mexico, Missouri, Oklahoma, Delaware, and Indiana. Some states, such as Indiana, never even require an LLC organizer to provide a principle place of business address. Other jurisdictions, such as New Mexico and Missouri, do not require annual reports to be filed by the LLC. Therefore, LLCs are generally more flexible and easier to operate in a private manner than corporations, and a nominee officer or manager may not be required in some (but not all) instances. Furthermore, if the LLC holds non-income producing property, then unlike a C or S corporation, no income tax return need be filed. Nonetheless, obtaining a "private" bank account normally entails a process similar to that used with obtaining private corporate accounts.

Nevada Corporations and 'Bearer Shares': A Bad Idea Without Legal Merit

Nevada corporations are not bad in and of themselves. They are just as legitimate a corporation as that which may be formed in any other state. However, as mentioned previously, Nevada corporations are notorious for being used for less-than-reputable purposes. What's more, such purposes are widely marketed nationwide. Such marketing of Nevada corporations takes many forms — from Internet sites promising to incorporate you on the cheap to a network of sales representatives pushing a Las Vegas-based program. Nonetheless, the legal theory behind the craze is almost always the same: because Nevada is the only state that allows 'nominee' directors and 'bearer shares' (which, the promoters claim, are as negotiable and easy to transfer as cash) no one can really ever know who owns a corporation at any time, because at any time anyone might have the 'bearer shares' in their pocket.

The theory appears to go something like this:

Because Nevada's corporate statutes (NRS) differ from the Revised Model Business Corporation Act as developed by the Committee on Corporate Laws of the American Bar Association in that NRS does not require that a stock certificate state the name of the person to whom the stock is issued, somehow the stock certificate can be made out simply to 'bearer' and thus, just like cash, whoever happens to be hanging onto the shares at any given time is the 'owner' for asset protection purposes. Thus, when a creditor hauls the person who has been running the corporation up until the morning of his testimony into court, that person can look the judge in the eye and state truthfully, "Gee, I don't know who owns the corporation, sir, since I just don't know where the 'bearer' shares are right now, or who's got 'em today. And whoever's got 'em is the owner — at least right now." The nominee director will likewise state that he has no idea who owns the corporation. Apparently, he's just given $1000 cash every year anonymously, and he's doesn't know who's currently holding the bearer shares, either.

Accordingly, the judge will shrug his shoulders, throw his hands in the air and confess, "Well, I guess that's the end of that. We just can't figure it out, so … CASE DISMISSED! Next?"

The debtor then scurries home, where his grandma, or whoever happens to be holding the stock certificates, says, "Welcome home, Sonny … here are those pesky papers you gave me this morning," after which life goes on unabated, since the debtor now has the stock (and thus ownership of the corporation) back in his hands, with the frustrated creditor stamping his feet in the background, muttering, "Curses! Foiled again by that darned Nevada 'bearer shares' law!"

That's the theory, at least. Unfortunately, this structure appears to be built on a pretty shaky foundation. Here's why:

First, there is no statutory or case authority that stands for the proposition that such a thing as 'bearer shares' exist in Nevada - at least not in the form pushed by its promoters. There are no Supreme Court opinions dealing with the concept, no Attorney General's opinions, no federal cases and, as far as we've been able to ascertain, no district court opinions upholding such a concept.

In fact, the whole 'bearer share' idea stems from this language, in Nevada Revised Statutes (NRS) §78.235(1):

> "Except as otherwise provided in subsection 4, every stockholder is entitled to have a certificate, signed by officers or agents designated by the corporation for the purpose, certifying the number of shares owned by him in the corporation."

That's it. There's not a word in Nevada statute that says 'bearer', no indication that the owner of a corporation can scam a creditor by claiming that he doesn't know who owns the corporation, and no provision that entitlement to a certificate equates to entitlement to hide from a valid debt.

In fact, Nevada case law appears to stand for just the opposite conclusion. As far back as 1942, the Nevada Supreme Court held that "a transfer of stock between individuals, in order to receive recognition by the corporation, must be registered upon its books."[178] This concept has been upheld as recently as 1986, in the case of *Schwabacher v. Zobrist*, which again confirmed that an ownership interest in a corporation is not valid as to the corporation until that interest is registered with the corporation. The case went on to say that when a stock transfer isn't registered on the corporate books, the person transferring the stock stands as a trustee for the person receiving the stock. Therefore, contrary to claims that Nevada law authorizes 'bearer shares' that can be transferred like cash, it appears that Nevada case law stands for the opposite proposition.

Second, under Nevada law, the holding of the stock certificate doesn't necessarily mean anything. In 1921, the Nevada Attorney General's Office issued an opinion that the stock certificate does not equate to the stock itself, but is merely a piece of paper evidencing ownership.[180] In all the intervening years, the Attorney General's Office has never modified or rescinded this opinion. In fact, because Nevada does not necessarily require that corporations issue certificates at all, it makes no sense to assume that possession of a stock certificate equals ownership of the shares anyway.

Along that same line, Nevada law provides that stock shares are personal property.[181] All rules, regulations and taxes that would otherwise apply to transfers of personal property would also apply to transfers of 'bearer shares,' if indeed such an animal exists. For example, my car is also my personal property. Handing my friend the keys until I got back from court wouldn't equate to transferring ownership, nor could I get away with telling a judge, "Gosh, your Honor, I don't know who's driving the jalopy right now, so I couldn't really tell you who owns the old clunker."

Thus, even if such a concept as 'bearer shares' did somehow exist under Nevada law, and even if the transfer of ownership of a corporation could somehow be accomplished with such ease, there would still be all sorts of estate, gift and capital gains tax issues. For example, the transfer of the 'bearer shares' to grandma would be a taxable gift under federal tax law. The re-transfer back would also be a taxable gift. The 'bearer shares' hustlers have somehow forgotten to mention this in their marketing materials.

Furthermore, there is also the possibility that the transferee of the bearer shares would also be hit with any judgment that had been levied against the transferor since, as the *Schwabacher* case stated, when an unregistered transfer of stock has occurred, the transferee of that stock is "responsible for the burdens and liabilities growing out of its ownership," at least as against the transferor of the stock. Presumably, this would carry with it any court order relative to the stock arising from the transferor's liabilities.

The tamest thing a judge would do under such circumstances would be to declare the debtor to be in constructive, if not actual, ownership of the shares and order the corporation to be liquidated to satisfy a creditor's claim. Most judges wouldn't sit still for that.

CHAPTER NINE

Limited Partnerships and Charging Order Fundamentals

For many years, the limited partnership (LP) has been a staple of asset protection planning. Although in many instances the limited liability company (LLC) is now preferable to the LP, limited partnerships are still popular, and are sometimes still the entity of choice, especially where the reduction of estate taxes is concerned.

Limited Partnership Fundamentals

Limited partnerships are a variation of the general partnership. General partnerships (which are commonly referred to as just "partnerships") have existed for thousands of years. They are typically small businesses wherein each partner may manage, act for, and bind the company. Although a general partnership is technically not a distinct artificial entity, as it is not created by the government, each partner usually contributes property to a general pool of partnership assets as necessary for it to conduct business, and it is often treated as a distinct entity. General partnerships are often very basic and informal in their structure, and are thus easy to form and operate. Only a minimum of legal hassles and associated paperwork (besides filing partnership tax returns) accompany the general partnership. Despite these benefits, however, as commercial law developed general partnerships gradually began to demonstrate some glaring shortcomings.

Among these shortcomings is the fact that one partner can make a decision that could financially harm not only the partnership as a whole, but the personal wealth of the other partners. Like a sole proprietorship, general partnerships have no limited liability. Therefore, if one partner obligates the partnership to debts it cannot pay, the personal wealth of all partners are at risk of being forfeit to the partnership's creditors. The same is true with debts arising from lawsuits: if one partner is dishonest or commits a tort while working for the partnership, then a creditor could obtain a judgment against the wrongdoer, the partnership as a whole, and each individual partner.

To cure these shortcomings, limited partnerships were formed under the idea that those who merely invest in a company without managing it should not be personally liable (beyond their original investment) for company debts. After all, they don't run or otherwise operate the company, they merely invest in it.

Limited partnerships were first allowed in accordance with Pennsylvania law in 1874.[182] They have been widely available in most states since 1916, when the Uniform Limited Partnership Act (ULPA) was drafted. Originally, limited partnerships were usually fairly small. The ULPA was not written to cater to the needs of large, multi-state or multi-national businesses. However, LPs grew in popularity and size over time, and by the 1970's many LPs had hundreds or even thousands of partners. One such LP would often operate in a large, even trans-continental, geographical area. The operation of such large companies was somewhat hampered by the limited scope of the ULPA. Subsequently, the Revised Limited Partnership Act (RULPA) was drafted in 1976 to address the ULPA's shortcomings, and the RULPA was in turn revised from time to time. Most states have subsequently adopted either the 1976 version of the RULPA or a subsequent revision. At the time of this writing, all states except Louisiana[183] have adopted some form of the ULPA or RULPA. One should note that where the ULPA or RULPA is silent, its parent act, the Uniform Partnership Act (UPA) or its revised version (RUPA) governs. Either the UPA or RUPA have likewise been enacted in all states except Louisiana.

The limited partnership's chief difference from the general partnership is its two classes of partners: general partners and limited partners. A general partner is a partner who manages the company. However, he has no limited liability. Consequently, if the company is unable to pay its debts, its creditors can look to the property of a general partner to satisfy those debts.

Limited partners do not suffer this same vulnerability. A creditor can only pursue a limited partner's assets to the extent those assets have been contributed to the partnership. This idea has been codified in the ULPA and its successors. At the same time, a limited partner is forbidden from managing or otherwise running the company. If a limited partner does manage the company, then he will likely lose his limited liability.

Because general partners, even in a limited partnership, have no limited liability, an LLC or corporation is often the general partner of an LP, which effectively gives the general partner limited liability. This is because although the LLC or corporation has no limited liability for the debts of the LP, those debts may not generally extend to the owners or managers of the LLC or corporation. This arrangement is especially useful if multiple individuals want to manage the partnership. Instead of having each person as a general partner, where their actions could expose other partners to liability, they can each be a manager of a single LLC or corporate officer or board member of a single corporation. Doing such would limit their exposure to the wrongful acts of the other managers, and allow everyone to participate in management of the LP.

Besides the distinction between limited and general partners, a limited partnership essentially operates like a general partnership. Consequently, LPs (before LLCs became popular) were often the entity of choice for small businesses. The reasons for this are threefold: a simple management structure, the lack of a requirement to follow corporate formalities, and partnership tax treatment.

Unlike corporations, which have a three-tiered management structure,[184] partnerships have a very simple and informal management structure. Basically, any general partner can make decisions for and bind the company. There is generally no requirement to draft a resolution or obtain the consent of the other general partners before doing such. This of course relieves the LP of the necessity of annual meetings, recording company resolutions, and keeping minutes of annual or other meetings of the general partner. With that said, some limited partnerships still choose to have such meetings and resolutions, and doing so is often a good idea. Nonetheless, doing such is not required by law.

Another major advantage of limited partnerships (which multi-member LLCs also enjoy) is partnership tax treatment. When compared to the corporation or sole proprietorship, a list of the more notable partnership tax benefits includes the following:

- Subject to certain restrictions, partners may distribute partnership income, gain, loss, or credit among the partners however they see fit. In other words, one partner may contribute little or no capital to the partnership, but receive a disproportionately larger share of partnership gain or loss, along with the tax benefits or liabilities associated with such. Compare this to a corporation, where a stockholder may only receive company profits in proportion to the amount of shares they own.
- Within certain limits, a partnership may distribute appreciated or depreciated property to a partner without recognizing gain or loss.[186] For example, let's say an individual bought a lot of raw land for $10,000. Ten years later he contributed it to the partnership, and eight years

after that it was redistributed to its original owner. At the time of distribution, the property's value had appreciated to $100,000. If the distribution had been made from a C or S corporation, the company (and also the shareholder, in the case of a C corporation) would have to recognize gain of $90,000, which means it would have to pay capital gains tax on $90,000 gain. Since there is no recognition of gain with a partnership in this instance, there is no requirement to revalue the property or pay the tax.

- Any partner may make additional contributions of appreciated property to a partnership at any time without recognizing gain on the property.[187] A new partner may also likewise make a contribution to an existing partnership without recognizing gain. If such contributions were made to a C or S corporation, however, gain would be recognized unless the contributor belonged to a group who, collectively, owned at least 80% of the partnership.[189] Recognizing gain, of course, is a term that means you have to pay capital gains tax to the extent your property appreciated in value.
- Distributions to limited partners are not subject to the self-employment tax, which can be quite burdensome.[190] Although C and S corporation distributions are also not subject to self-employment taxes, general partnerships and sole proprietorship profits are usually subject to this tax. Note that a general partner's interest in an LP may still be subject to self-employment taxes, however this exposure is often reduced by giving the general partner a smaller (1% or so) interest in the company (the general partner's management salary, however, is still subject to self-employment or the equivalent FICA/FUTA taxes).
- When a partnership partially or completely buys out a partner's interest, the remaining partners receive a step-up in basis of that partner's share, to the extent that partner recognized gain.[191] In layman's terms, this means that the bought-out partnership interest, and the capital connected to it, is re-valued to its current fair market value without triggering capital gains tax. If the partner's interest is sold for more than what it was worth when he bought into the partnership, the partner will recognize gain, but the partnership will receive the step-up. Corporations do not receive this benefit, meaning that even if a shareholder sells his company interest for a profit, gain (with no tax break) will still be recognized when appreciated company assets are distributed. This step-up in basis also occurs if a partnership interest is transferred due to a 3rd party purchase, death of the partner, or otherwise.[192]
- In some circumstances, partnership liabilities may be used to offset the individual tax liabilities of each partner.[193]

- As we'll discuss later in this chapter, limited partnerships may be used to reduce estate tax liability while passing company interests tax-free to one's heirs. These tax reduction strategies are not available to C or S corporations, general partnerships, or sole proprietorships.

Although there are many benefits to partnership taxation, there are instances where other tax classifications are more desirable, or where partnership taxation is a hindrance rather than a benefit. However, most tax advisors consider partnership tax law to be the most favorable, in most circumstances, to an entity and its owners.

Minimizing General Partner Interests

The previous section describes how limited partnership interests are not subject to self-employment taxes. Later in this chapter, we'll also discuss how limited partnership interests may be used to reduce estate taxes. Because of these tax benefits, a common arrangement is to have a 1% general partner and have the rest of the interests held as limited partner interests. The general partner may manage the entire partnership, even if he holds only a 1% interest. However, what if the general partner wanted a more substantial interest in the company? The answer is simple: the law allows a person to be both a general and limited partner of the same partnership.[194] Therefore, if an individual wishes to hold a 50% total interest in an LP, as well as manage the LP, he could hold his interest as a 1% general partner and 49% limited partner.

The Limited Liability Partnership (LLP) and Limited Liability Limited Partnership (LLLP)

Limited partnerships should not be confused with the limited liability partnership (LLP) or the LP's close relative, the limited liability limited partnership (LLLP). LLPs are not normally used for asset protection. This is because each partner does not have limited liability from company debts. Instead, each partner is a general partner that is not liable for the actions of the other partners. For example, if an LLP accounting firm has five accountants as partners, and one partner commits a professional error, then the other four partners will not be held responsible for that error (remember, if the partnership were a general partnership, all partners would be liable for the wrongful act of any one partner.) For this reason, LLPs are popular amongst attorneys, CPAs, and other professionals, even though each partner is still liable for their own individual errors as well as company debts. As a rule, licensed professionals may only practice as sole proprietors, or as owners or partners of an LLP or professional entity (such as a professional LLC, professional corporation, or professional association.) By law, none of these entities may limit a professional's liability from his own errors or malpractice. However, since it is still beneficial to protect one's self from the potentially wrongful acts of one's partners, the simplified structure of an LLP is often desirable to the practicing professional.

The LLLP is actually quite similar to the LP, wherein it has both limited and general partners. However, the LLLP also gives its general partners the benefits of an LLP. This means that each general partner is protected from the consequences of another partner's wrongdoing. At the time of this writing, however, only a few states allow one to form an LLLP.

Limited Partnerships and the Charging Order

Though we have discussed several benefits of the LP, we have not yet discussed its biggest benefit from an asset protection perspective. This benefit is the charging order. To say the charging order is a benefit is actually a bit of a misnomer, because in actuality the charging order is a remedy available to creditors. However, the remedy is so limited that it is often ineffective. That is why, amongst the over 20,000 entities the authors have created (most of which a creditor may obtain a charging order against), less than five have ever been subject to a charging order. Furthermore, if an LP is created and operated correctly, then a creditor will have no other way to reach LP assets besides the charging order. So what is the charging order?

The charging order is a statutory provision of law under the UPA, ULPA, RULPA, and Revised Uniform Limited Liability Company Act (RULLCA) wherein a creditor of a company's partner or owner may attach company distributions made to that individual. However, this is generally the *only* remedy available to the creditor. This is so because it would not be fair to the other partners, or to the partnership, if a creditor were able to disrupt partnership business. Doing so would harm the other partners, who are *not* parties to the debt. Consequently, the charging order does not allow the creditor to gain control of an entity, attach the entity's assets, or become a partner or owner of the entity. Of critical importance is the fact that, since a charging order holder cannot control the entity, they cannot control when distributions are made. In other words, if the entity never makes a distribution to the debtor-partner, then the creditor never receives a distribution, meaning their charging order is essentially worthless. A note of caution here: it is not a good idea to make distributions to all partners *except* the partner whose interest has been assigned to a creditor via a charging order. A judge might see this as an overt attempt to thwart the creditor from receiving his due. In such an instance, it is conceivable that a judge could view such circumstances as being akin to a fraudulent transfer, which might then lead him to force a distribution from the entity. If an individual wishes to have distributions made to the other partners or owners while keeping his distribution out of the hands of creditors, then before the creditor threat arises he should place his company interest in another entity that is also protected by the charging order. Then the distributions will be made to the 2nd entity and not to the individual directly. This strategy is discussed more thoroughly in Chapter 19.

Because proper planning turns the charging order from a creditor remedy to a shield against creditors, any entity to which a charging order may apply is called a Charging Order Protected Entity, or COPE. The following entities are COPES:

- Limited partnerships.[195]
- General partnerships.[196]
- Limited liability partnerships.[197]
- Limited liability limited partnerships.[198]
- Limited liability companies (in some jurisdictions, only multi-member LLCs have charging order protection).[199]

Note that corporations are *not* COPES. If a corporate shareholder comes under creditor attack, that creditor may seize all his shares of stock, up to the amount of the outstanding debt. If the shares seized exceed 50% of all the company's voting shares, the creditor could then vote to liquidate the company, and seize his share of company assets upon liquidation. The vulnerability of corporate shares to creditor attachment thus makes the corporation a relatively poor asset protection vehicle.

Foreclosure of the Charging Order: No Big Deal or a Fatal Blow to Charging Order Protection?

As partnership and LLC law has evolved, the various related uniform acts have allowed for the foreclosure of a charging order. Some states, such as California[200] and Nevada[201], have adopted these changes, while other states, such as Oklahoma's LLC Act[202], have adopted legislation that appear to forbid or restrict the effects of such foreclosure. Still other states have yet to adopt these changes one way or another.

Some individuals, and even some of the less-informed asset protection planners, fear the foreclosure of a charging order undermines the protection that COPEs have previously provided. A careful reading, however, shows this to not be the case.

To illustrate, let's examine section 703(b) of the RULPA.

> "(b) A charging order constitutes a lien on the judgment debtor's transferable interest. The court may order a foreclosure upon the interest subject to the charging order at any time. *The purchaser at the foreclosure sale has the rights of a transferee.*" [Emphasis is ours.]

The key sentence here is that a purchaser of a foreclosed charging order has the rights of a transferee. What are those rights? Section 702 of the Act tells us:

> "(a) A transfer, in whole or in part, of a partner's transferable interest:
>
> …
>
> (2) does not by itself cause the partner's dissociation or a dissolution and winding up of the limited partnership's activities; and
>
> (3) *does not*, as against the other partners or the limited partnership, *entitle the transferee to participate in the management or conduct of the limited partnership's activities,* to require access to information concerning the limited partnership's transactions except as otherwise provided in subsection (c), or to inspect or copy the required information or the limited partnership's other records.
>
> (b) *A transferee has a right to receive*, in accordance with the transfer:
>
> (1) *distributions to which the transferor would otherwise be entitled*; and
>
> (2) *upon the dissolution and winding up of the limited partnership's activities the net amount otherwise distributable to the transferor.*
>
> (c) In a dissolution and winding up, a transferee is entitled to an account of the limited partnership's transactions only from the date of dissolution.
>
> (d) *Upon transfer, the transferor retains the rights of a partner other than the interest in distributions transferred and retains all duties and obligations of a partner*." [Emphasis is ours.]

The foregoing illustrates that foreclosing a charging order only gives the purchaser the rights of a charging order in perpetuity. In other words, a charging order is effective until the judgment is satisfied, but a foreclosed charging order extends those rights indefinitely. No other rights or powers arise from the foreclosure.

So how bad is it for someone to now hold a perpetual charging order interest? If the entity is structured correctly, then a foreclosed charging order will rarely be worse than an unforeclosed one. This is because, due to IRS Rev. Rul. 77-137, the holder of a foreclosed charging order will almost certainly receive the tax bill for his share of company profits, even if he never receives those profits. In other words, having a foreclosed charging order not only doesn't ensure its holder will ever receive anything from the partnership, it also *does* ensure he'll receive the tax bill for whatever it is he didn't receive! Structuring an entity so as to lay this trap for unsuspecting creditors is discussed in Chapter 19.

Of course, if a foreclosed charging order ends up being all pain and no gain for the creditor, he will want to get rid of it, meaning that the foreclosed charging order will almost certainly not be in effect indefinitely.

Does it Really Matter Whether a State's Laws Specify the Charging Order as the Exclusive Remedy of a Creditor of a Partner?

The short answer is no, it doesn't matter whether a state's law specifies the charging order as an exclusive creditor remedy, so long as the entity is properly structured. This is because the only other creditor remedy is to reverse-pierce the entity. Reverse-piercing an entity allows a creditor to seize company assets to satisfy the debts of one of its owners. However, if doing so would unfairly harm an innocent 3rd party, such as another owner of the entity or a creditor of the entity (not to be confused with a creditor of the entity's owner(s)), then a judge will generally *not* allow a reverse-pierce. This is the same reason why the charging order is a very limited creditor remedy: if the creditor is able to directly attach a COPE's assets, or manage the COPE, then innocent 3rd parties may be harmed. Therefore, the creditor is not generally allowed more than a charging order. Across the nation, courts have generally ruled in a consistent manner in regards to this matter.[203]

This brings us to a very important key of asset protection planning: asset protection will almost never fail if 3rd parties are involved in a manner so that piercing a structure would unfairly harm them. This maxim is the reason for favorable court rulings regarding reverse piercing, for charging order statutes being written as they are, and for §8(a) of the Uniform Fraudulent Transfers Act (the UFTA, which we examine in Chapter 5). Remember, §8(a) forbids a property transfer from being undone *even if that transfer was done with intent to hinder, delay, or defraud a creditor*. Why? Because undoing the transfer would, in the instance described in §8(a), unfairly harm the other party to the transfer. This is a very, very powerful principle of asset protection planning. The chapter of this book entitled "Asset Protection a Judge Will Respect" examines this principle in greater detail.

Family Limited Partnerships (FLPs) and Estate Planning

As we discussed earlier in this book, asset protection is most effective when combined with other types of planning, such as business, retirement, and estate planning. The FLP achieves both significant asset protection and estate planning benefits, and is thus a staple tool of every asset protection planner. The FLP is actually no different from a normal LP, except that its partners consist of family members. To that end, all the asset protection benefits of an LP are inherent with any FLP.

A typical FLP has an heir or heirs own a 1% general partner interest, and the parent(s) contribute assets to the limited partnership in exchange for a 99% limited partner interest. FLPs are used to reduce or eliminate estate taxes, and there are two strategies used to achieve this: valuation discounting and gifting (or, even better, split gifting). We'll discuss each of these strategies in turn.

The valuation discount strategy is based on the principle that a limited partnership interest has less value than the assets transferred into the partnership in exchange for that interest. There are two reasons for this principle: lack of marketability and lack of control.

A properly drafted limited partnership agreement will not allow the limited partner to sell his interest without the consent of the other partners. Furthermore, the limited partner has no right to a return of property once it is contributed to the partnership. This constitutes a lack of marketability (sometimes called "non-liquidity"), which is an inability to sell the partnership interest or the assets contributed to the partnership.

The lack of control discount arises from the fact that a limited partner has no power to manage the partnership. Since the property he contributed now belongs to the partnership he has no control over, he no longer controls the property. This also makes his limited partnership interest less valuable than the property he contributed to it (which now belongs to the partnership and is thus no longer part of his estate), meaning his limited partnership has a discounted value when compared to the property he contributed. This discount generally ranges from 10% to 40%. This means, of course, that an individual's estate is worth less in regards to estate taxes, and therefore the estate tax upon an individual's death may be significantly lower.

For example, let's suppose a divorced woman, Sally, has $5 million in assets. She contributes $2 million to a limited partnership in exchange for a 99% limited partner interest. Her son, Jeff, contributes $20,200 and is the 1% general partner. An estate planner values the limited partnership interest at a 30% discount, meaning her partnership interest, for estate tax purposes, is worth $1.4 million ($600,000 less than the value of her contributed property). Assuming a 47% estate tax rate, upon Sally's death she'd realize an estate tax savings of $282,000.

The valuation discount may be combined with gifting of limited partnership interests. The Internal Revenue Code allows an individual to gift $12,000 annually without incurring tax consequences.[204] Therefore, Sally could gift $12,000 worth of limited partnership interests to each heir each year. Remember, in Sally's case her limited partnership interests are worth less than the property she contributed to the partnership. Therefore, gifting a $12,000 limited partnership interest can be seen as gifting $17,142.85 of assets out of Sally's estate each year. If Sally was married, then she could gift even more out of her estate each year. That's because a married couple can each gift $12,000. Therefore, a married couple could each make a combined gift of $24,000 to each heir annually. When a married couple makes a gift in such a manner, it's called a "split gift". Now let's suppose Sally is married and has three children. She can then split gift $24,000 in limited partnership interests to each child each year, tax free. This amounts to $72,000 in tax-free gifts annually. If we look at the value of assets she contributed to the partnership, in this instance she'd actually be reducing her taxable estate by $102,857.10 each year. Over a ten year period, she will have reduced her estate by $1,028,571, which would save her approximately $483,428 in estate taxes, in addition to the savings she realizes through a valuation discount of the partnership interest she still owns. Obviously, an FLP, when utilized properly, can be a very powerful estate tax reduction tool.

Using FLPs with Other Estate Planning Strategies

We can further enhance the FLP by combining it with certain trusts as part of an overall, comprehensive estate plan. For example, Sally may not wish her son to outright manage the limited partnership. She can instead have an irrevocable trust own the 1% general partnership interest, with an impartial 3rd party (such as a bank or trust company) as trustee. The trust may of course provide rules and guidance as to how the partnership is to be managed by the trustee. Since the trust manages the partnership, it can then decide when and to what extent assets are distributed from the partnership after Sally dies, which would help prevent her heirs from squandering their inheritance.

Another benefit a trust could provide is to keep Sally's partnership interest from going through probate upon her death. Probate is the court-appointed process of distributing wealth to one's heirs after they die. It is often very costly (up to 5% of the estate's value, or $250,000 in Sally's case), and can take years to complete. Sally can keep her limited partnership interests out of probate by placing them in a revocable living trust. If Sally's heirs are under the age of 18, or if she wants an extra layer of asset protection, she can also gift limited partnership interests to an irrevocable children's trust. This trust may provide some additional asset protection, in some circumstances, against both Sally's creditors and her children's creditors. Care should be taken, however, so that the annual $12,000 gift (or $24,000 split gift) may still be made on a tax-free basis, as an improperly drafted trust will not be able to accept tax-free gifts in this manner. We'll more thoroughly discuss how to structure these trusts to achieve the foregoing benefits in chapters 13 and 14 of this book.

Can a Family LLC (FLLC) Provide the Same Benefits as a FLP?

Many practitioners prefer to use an FLP instead of an FLLC for estate tax reduction. This is because FLPs are "tried and true" and have a plethora of case law to support their efficacy.[205] However, it is possible to structure an FLLC like an FLP to for the purposes of estate tax reduction. There is no case or statutory law that would prohibit this. At the same time, FLLCs have not been battle-proven in court, as has the FLP.

To make sure an FLLC is taxed like an FLP, it should be structured like an FLP. Namely, the company should have limited members (a "member" is the LLC's equivalent to a partner) and managing members, and it should be taxed as a partnership. It should also have all the characteristics of an FLP that we'll discuss in the following section.

With the more battle-tested track record of the FLP, one might ask: why would anyone wish to form an FLLC instead of an FLP? An FLLC does have some benefits that an FLP does not. Namely:

- The LLC may exist perpetually (LPs typically may only exist for 30 years.)
- The LLC enjoys limited liability for managing members as well as limited members. Remember, the general partner (manager) of an LP has no limited liability.
- After the death of the parent, an LLC may elect to be taxed as a C or S corporation. An LP must stay with partnership taxation without exception.

Albert Strangi v. CIR: A Case Study of How NOT to Use a Family Limited Partnership

Merely forming, funding, and using an FLP does not by any means guarantee you will realize estate tax savings and asset protection. Indeed, there are many pitfalls that an individual may fall into if they do not have the proper knowledge required to properly form and operate an FLP. The infamous case *Albert Strangi v. CIR*[206] is an excellent of example that illustrates many if not most of these pitfalls. It shows that estate planning and asset protection are *not* do-it-yourself endeavors, and how improper planning can have disastrous, financially painful results. To illustrate, let's examine the case.

Albert Strangi lived in Waco, Texas, and had an estate worth approximately $10 million. In 1993, he began to experience serious health problems. As a result, he turned over the management of his daily affairs to his son-in-law, Michael Gulig, who was a local attorney. In August, 1994, Mr. Gulig attended a seminar regarding the use of FLPs for asset protection, charitable giving, and estate and other tax reduction strategies. A mere seven days later, he had put together an asset protection and estate tax reduction structure that would purportedly shelter almost all of Mr. Strangi's estate.

Essentially, Albert Strangi contributed $9,932,967 of his estate to the Strangi Family Limited Partnership (SFLP) in exchange for a 99% limited partner interest in the company. The 1% general partner was a Texas corporation, Stranco, Inc. (Stranco). Albert contributed $49,350 to Stranco in exchange for a 47% interest, and his children contributed $55,650 for a 53% interest. Stranco then contributed its funds to SFLP in exchange for a 1% general partner interest. Upon his death, Albert's estate valued his limited partnership interest at $6,560,730, a discount of $3,372,237.

Two months later, Albert died, and the IRS eventually challenged the FLP under §2036(a) of the Internal Revenue Code. §2036(a) states that:

> "The value of the gross estate shall include the value of all property … of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth) …under which he has retained for his life…
>
> 1) the possession or enjoyment of, or the right to the income from, the property, or
> 2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

In simpler terms, this means that if a person transfers an asset yet retains possession, enjoyment, rights to income from the property, or the right to designate who will receive such, then the asset is included in his estate for purposes of calculating estate tax liability. The one exception is if the asset is transferred via a bona fide sale at fair market value.

The IRS argued that, under §2036, the full value of the assets that Albert transferred to the FLP should be included in his gross estate (thus negating the valuation discount his estate had claimed) because:

1) Albert's transfer of his property to the FLP was not a bona fide sale for full and adequate consideration;
2) Albert, and his estate after his death, retained use and enjoyment of the FLP's property; and
3) Albert retained the right to designate who should possess or enjoy the FLP's property.

The tax court agreed with the IRS on all three arguments, and the appeals court agreed on the first two arguments without trying the third. An examination of why the appeals court agreed with the IRS is very instructive, for it shows us what not to do when forming and operating an FLP.

The first argument is the most important. If a transfer to an FLP is considered a bona fide sale at full and adequate value, then §2036 of the Internal Revenue Code does not apply, and we need go no further. The court actually held that the transfer was for full and adequate value. It noted that, "Where assets are transferred into a partnership in exchange for a proportional interest therein, the "adequate and full consideration" requirement will generally be satisfied, so long as the formalities of the partnership entity are respected… [as] has been the case here."

In regards to the bona fide sale requirement, the court relied on *Kimbell v. U.S.*,[207] which said that a sale is bona if it had a "substantial business [or] other non-tax" purpose. The court then noted the following:

- SFLP never made any investments or conducted any active business following its formation.
- Albert Strangi's children's combined contributions of $55,560 were, in relation to overall contributions, de minimis (so small as to be inconsequential), and therefore SFLP could not be seen as a joint investment venture. (Note that the $55,560 contribution was only about 0.5% of all contributions.)
- The overwhelming majority of the assets transferred to SFLP did not require active management.

Because the bona fide sale criteria was not met, the IRS was allowed to challenge SFLP under §2036(a), saying that the property transferred to SFLP should be included in Mr. Strangi's taxable estate because he retained rights to use and enjoy the property. The facts that led the court to agree with the IRS were as follows:

- Almost all of Mr. Strangi's property was transferred to SFLP, to the extent that he had insufficient funds to live on for the rest of the 12 to 24 months he was expected to live.
- Mr. Strangi continued to live in his home, which he had transferred to SFLP. His estate eventually paid rent to SFLP for the time Mr. Strangi lived there, but the rent wasn't paid until two years after the fact.
- Perhaps most damning was the fact that, on numerous occasions, property was transferred back out of SFLP to pay Mr. Strangi's costs of living, as well as to pay for Albert's funeral expenses, personal debts, estate administrative costs, and state and federal estate taxes. Obviously, if Mr. Strangi and his estate was able to access his property that easily, he must have retained rights to use and enjoyment of the property in accordance with §2036(a)(1).

The final argument raised by the IRS was that Mr. Strangi retained the right, in conjunction with the other owners of Stranco (the general partner of SFLP), to manage the limited partnership and thus designate who may enjoy the use, possession, or rights to income of partnership property, and thus the property he transferred to the partnership should be included in his gross estate under §2036(a)(2). The tax court here agreed with the IRS.[208] Many professionals believe the tax court's interpretation of §2036(a)(2) was overly broad,[209] however the appeals court never heard this issue so, unfortunately, we don't know whether they would have agreed with the lower court. Nonetheless, we should note the reasons why the IRS took this position in the first place. If possible, then, one should structure an FLP so that the person wishing to reduce estate tax liability is not a general partner, and has no interest in the entity that is a general partner. Even better, an independent fiduciary could be hired to manage the partnership.

In light of the *Strangi* case, there are several things we can do to reinforce an FLP so as to withstand IRS scrutiny. First and foremost, the FLP should have a bona fide business purpose. Having a secondary non-business, non-tax purpose is also good, but courts other than the one in *Strangi* have ruled that, since limited partnerships are business entities, they should always have a business purpose to avoid being seen as an individual's alter-ego.[210] If an FLP's primary business activity is investing, then those investments should be actively managed, meaning there should be some significant trading activity from time to time. Having an FLP hold purely passive investments that never change (an S&P 500 index fund, a CD, municipal bonds, etc.) may not be sufficient. This problem is easily solved by making some trades every few months (yet the trading should be more than a de minimis amount). It almost goes without saying that a strictly personal asset, such as a home, should never be placed in an FLP, or any limited partnership, for that matter, but we'll say it anyway.

Remember: if a court rules that an FLP has a legitimate business purpose, then the IRS is not allowed to use §2036 of the Internal Revenue Code to negate the limited partnership's valuation discount. Nonetheless, since adding extra layers of protection is usually a good idea, it's a good idea to structure an FLP, to the extent it's feasible, so as to withstand an IRS assault in accordance with §2036. This is done by observing the following:

- Make sure the individual who is trying to reduce estate tax liability (the original contributor) is not a general partner of the FLP, and make sure they have no voting rights in any entity that is a general partner (for example, they should not hold voting shares of a corporation that acts as the FLP's general partner). Best of all, hire an independent fiduciary as the general partner, or as the manager of an entity that is the general partner.
- The partnership's operating agreement should not give the original contributor the right to amend the operating agreement or change the managers or general partners of the company.
- Keep enough assets out of the FLP to pay for living expenses, personal debts, funeral expenses, taxes, and expenses of your estate after you die.
- Avoid returning limited partnership property to the original

contributor. If a distribution must be made, adjust partnership interests accordingly, or make a pro rata distribution to all partners. FLP profits may be proportionally distributed to its partners in accordance with standard business practice, of course.

- Run the FLP like an actual business entity that is separate from the individual partners, and keep all transactions at "arm's length". Observe the terms of the operating agreement and keep proper books and records.
- Make sure all partners have at least a 1% interest in the partnership. Their contributions to the FLP should be proportional to the contributions other partners made in exchange for their membership interests. If a family member doesn't have enough property to contribute in exchange for a 1% interest, have them give a promissory note to the partnership. The promissory note should bear interest at a reasonable rate. A parent may then make annual gifts to the heir, so that the heir can pay off the promissory note.

A final question to answer is: how might Mr. Strangi's FLP have fared under a traditional creditor attack? After all, the case at hand involved an IRS tax assessment, and not a lawsuit brought by a private party. We feel that many of the shortcomings that caused SFLP to fail from an estate planning perspective would also cause it to fail under a creditor's attempt to pierce the entity to seize assets. For example, SFLP had no business purpose, which the courts have ruled would be grounds in and of itself to pierce the entity.[211] The entity also held strictly personal assets, such as a home, which could justify a veil-pierce. Furthermore, although the occasional return of partnership capital would not be considered commingling, returning capital frequently to cover non-business expenses might be considered commingling, which is also grounds for piercing the partnership. Finally, the fact that other partnership members owned less than 1% of the partnership may lead a judge to disregard their ownership as de minimis. This would mean the partnership could be treated as if it was owned by only one individual. As we'll see in the next chapter, single-owned entities are often susceptible to reverse piercing, and may not benefit from charging order protection.

Therefore, the guidelines we've given for operating an FLP for estate planning purposes are also applicable if one wishes to use an LP for asset protection. The one exception is that, in some circumstances, it may be OK for the individual seeking asset protection to be the general partner of an LP, if there are no known or suspected creditor threats at the time of the partnership's formation and capitalization.

There is final lesson we can learn from the *Strangi* case. Remember: when doing this type of planning you are trying to protect your *entire life savings*. The stakes are very high! Too often the authors of this book see individuals who would rather use a shaky plan, implemented by an unskilled planner, in order to save money, instead of paying a bit more for a comprehensive, effective structure put together correctly by a skilled professional.

CHAPTER TEN

Using Limited Liability Companies for Domestic Asset Protection

Limited Liability Company Fundamentals

The limited liability company, or LLC, originated in Germany in 1892, with the Gesellschaft mit beschrnkter Haftung, or GmbH, which literally means "company with limited liability". The GmbH concept was quickly adopted in many countries[212] before it came to the U.S. under Wyoming's Limited Liability Company act of 1977.

At first, LLCs in the U.S. were unpopular, mostly because of the uncertainty that surrounded their tax treatment. Finally, in 1986 the IRS issued guidance on how to treat LLCs for tax purposes. As a result, LLC formations grew exponentially and even more so with the IRS's introduction of "check-the-box" regulations in 1996 (these regulations are explained below). Today, LLCs are by far the most popular limited liability entity in the U.S., with well over a million in use.

In many ways, the LLC is similar to the limited partnership. An LLC's management structure is typically identical or similar to the management structure of a partnership. It can have all members (the term used for LLC owners) act as managers, like a general partnership, or it can have managing members and limited (non-managing) members, like a limited partnership. Alternatively, it can hire a manager who has no ownership interest in the company. Although not as common, it can even have its management structured so as to be similar to that of a corporation. However, like the corporation, all owners of an LLC have limited liability, even its managers. And, like partnerships, LLCs benefit from charging order protection. For this reason, LLCs are often considered a hybrid entity, combining the best features of both the corporation and the partnership.

Perhaps the best feature of an LLC is its flexibility. Not only may an LLC structure its management in almost any way it sees fit, it may also create different classes of ownership, if desired, to best suit its needs. This is allowed because the LLC statutes of all 50 states give an LLC's governing document (typically called an operating agreement) wide latitude in determining how an LLC operates. In fact, most LLC statutes are "default statutes",[213] meaning they only take effect if an LLC's operating agreement does not specify otherwise.

Further enhancing an LLC's flexibility is its ability to choose its tax classification. Of course an LLC may be taxed according to its default status, which is partnership taxation for a multi-member LLC, or as an entity disregarded from its owner for tax purposes ("disregarded entity" or sole proprietorship taxation) if it has only one underlying taxpayer. An LLC has unparalleled flexibility, however, in that fact that it may also elect to be taxed as a C or S corporation by completing the appropriate IRS form(s).[214] Note, however, that if an LLC chooses to be taxed as an S corporation, then it must meet S corporation eligibility requirements. This means, among other things, that it may have no more than 100 members, and each member must be natural U.S. citizen, a qualified trust, a qualified S corporation, or a disregarded entity whose owner is a natural person.[215]

An LLC may also have multiple members yet, in some cases, be taxed as a disregarded entity. We'll discuss disregarded entity multi-member LLCs (DEMMLLCs) near the end of this chapter.

When Not to Form an LLC

With unparalleled flexibility, limited liability for all members and managers, charging order protection, and the lack of a statutory requirement to observe corporate formalities, one might ask "why shouldn't all entities be LLCs, since LLCs seem to be superior to all other entity types?"

That's a good question! Although the benefits of LLCs lead the authors to form more of them than any other entity type, there are still instances in which other entity types are preferable. For example:

- Many practitioners feel the family limited partnership is a more established and battle-tested estate planning tool than its counterpart, the family LLC (FLLC).

- Some states levy a franchise tax on LLCs, which may be avoided or minimized by instead forming a limited partnership.[216]
- Publicly traded companies are typically corporations, because of the fact that corporate stock may easily change ownership without the consent of other shareholders. LLCs are not designed to allow the easy transfer of company ownership interests.
- LLCs are business entities and are not meant for holding strictly personal assets such as a home. Strictly personal assets should be protected either via equity stripping (which is discussed in Chapter 15), or in some form of trust as appropriate for the particular situation (trusts are discussed in Chapters 11 through 14). Note that cash and investments can almost always be used for business purposes, and thus an LLC is often a great way to protect such assets.

Notwithstanding the above, we should note that although there are instances where C corporations, trusts, or limited partnerships are the entity of choice, the S corporation is more or less obsolete. This is because S corporations are statutorily limited in size, and thus are not suitable to be publicly traded, which is probably the only valid reason for forming a C corporation rather than an LLC that chooses to be taxed as a C corporation. Since LLCs can choose to be taxed as an S corporation, there remains no significant advantage of having an S corporation instead of an LLC that is taxed as such. Rather, because S corporations lack charging order protection they are at a disadvantage when compared to LLCs that make the subchapter S tax election. For this reason, many clients approach us with the request to convert their S corporation into an LLC taxed as such.

Single Member LLCs and Charging Order Protection

In the past, there was much confusion regarding whether a single member LLC benefited from charging order protection. A 2003 court case cleared up most misconceptions. This particular case, *In re: Ashley Albright*,[217] was part of a Chapter 7 bankruptcy proceeding wherein the debtor, Ashley Albright, owned and managed Western Blue Sky LLC as its only member. After declaring bankruptcy, the bankruptcy trustee motioned to obtain 100% ownership of the LLC, in order to liquidate its assets and pay the bankruptcy estate's creditors. Ms. Albright argued that charging order statutes mandated the trustee was only entitled to distributions from the LLC if and when they were made, and not to the assets or a membership interest in the LLC itself.

It is important to note that the governing law used here is the Colorado LLC Act. The judge ultimately decided that Colorado's LLC Act does not avail a single member LLC of the charging order. He specifically noted that:

> "Upon the Debtor's bankruptcy filing, she effectively transferred her membership interest [in Western Blue Sky LLC] to the [bankruptcy] estate… Because there are no other members in the LLC, the entire membership interest passed to the bankruptcy estate…"

The judge based his reasoning on § 7-80-702 of Colorado's LLC Act, which provides:

> "The interest of each member in a limited liability company… may be transferred or assigned. However, if all of the other members of the limited liability company *other than the member proposing to dispose of his or its interest* do not approve of the proposed transfer or assignment by unanimous written consent, the transferee of the member's interest shall have no right to participate in the management of the business and affairs of the limited liability company or to become a member. The transferee shall only be entitled to receive the share of profits or other compensation by way of income and the return of contributions to which that member would otherwise be entitled." [Emphasis is ours.]

The court interpreted this to mean that "because there are no other members in the LLC, no written unanimous approval of the transfer was necessary. Consequently, the Debtor's bankruptcy filing effectively assigned her entire membership interest in the LLC to the bankruptcy estate..."

What this means, then, is that in the state of Colorado, a single member LLC won't protect one's assets in bankruptcy. This is because when a solely-owned LLC member declares bankruptcy, he is essentially declaring the transfer of his LLC membership interest to the bankruptcy estate. This also means the LLC acts of other states may likewise offer no asset protection to a single member LLC in bankruptcy. This will depend, of course, on a state's particular LLC Act. Some states do not have the same or similar language as contained in Colorado's LLC Act,[218] which is what led to the court's determination in this instance. However, this same case uses a second rationale for denying a single member LLC charging order protection that is not necessarily reliant on the language of any particular act, and which can and has been used in other jurisdictions[219] even outside of bankruptcy:

> "The Debtor argues that the Trustee acts merely for her creditors and is only entitled to a charging order against distributions made on account of her LLC member interest. However, the charging order… exists to protect other members of an LLC from having involuntarily to share governance responsibilities with someone they did not choose, or from having to accept a creditor of another member as a co-manager. A charging order protects the autonomy of the original members, and their ability to manage their own enterprise. In a single member

> entity, there are no non-debtor members to protect. The charging order limitation serves no purpose in a single member limited liability company, because there are no other parties' interests affected."

The foregoing may prove to be a most dangerous piece of case law to single member LLCs, as it sets a precedent that will likely lead to similar rulings towards LLCs organized in other states, even in non-bankruptcy cases.

> The silver lining to this shadow is that In re: *Ashley Albright* reinforces the charging order protection of multi-member LLCs. As the court notes:
>
> "…the result would be different if there were other non-debtor members in [Ashley Albright's] LLC. Where a single member files bankruptcy while the other members of a multi-member LLC do not, and where the non-debtor members do not consent to a substitute member status for a member interest transferee, the bankruptcy estate is only entitled to receive the share of profits or other compensation by way of income and the return of the contributions to which that member would otherwise be entitled.
>
> …
>
> The harder question would involve an LLC where one member effectively controls and dominates the membership and management of an LLC that also involves a passive member with a minimal interest. If the dominant member files bankruptcy, would a trustee obtain the right to govern the LLC? …if the non-debtor member did not consent, even if she held only an infinitesimal interest, the answer would be no. The Trustee would only be entitled to a share of distributions, and would have no role in the voting or governance of the company."

Notwithstanding the above, there is a later court case,[220] which is only applicable in bankruptcy, that may cause even a multi-member LLC to lose its charging order protection if it is structured improperly. There are also other non-bankruptcy cases that, in rare circumstances, may allow a creditor to disregard the charging order protection provided by a multi-member LLC, if it is not structured properly.[221] Be sure to read about these cases in the chapter of this book entitled "Asset Protection a Judge Will Respect."

Does the foregoing mean a single member LLC will never have any charging order protection under any circumstances? No, it doesn't. There are a few reasons for this. First, this matter has not been settled in all jurisdictions, and as previously noted not all LLC acts contain the same detrimental language as Colorado's. Second, to disregard charging order protection is to allow a reverse-pierce of an entity. Sometimes a judge will not allow a reverse-pierce (a reverse-pierce being where a creditor of a company's owner can seize company assets or control of the company), based on circumstances other than whether other members of an LLC are harmed or not. For example, one court has noted that:

> "We recognize … that there are other equities to be considered in the reverse piercing situation -- namely, whether the rights of innocent shareholders *or creditors* are harmed by the pierce."[222] [Emphasis is ours.]
>
> Another court similarly notes:
>
> "In addition, the reverse-pierce theory presents many problems. … third parties may be unfairly prejudiced if the corporation's assets can be attached directly. Although … our particular concern was with non-culpable third-party shareholders of the corporation being unfairly prejudiced, no greater culpability should attach to the third-party corporate creditors harmed by reverse-piercing in this case." [223]

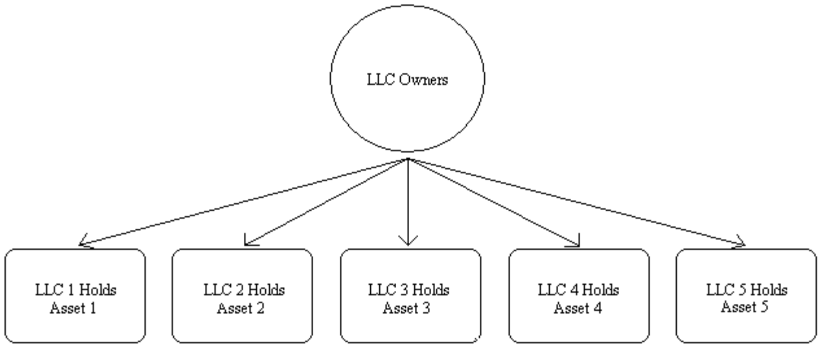
The above leads us to believe that a single member LLC may not be reverse-pierced if doing so would harm creditors of the LLC. Nonetheless, given all the facts, we must conclude that one cannot rely on a single member LLC to provide meaningful protection against a creditor of its owner. Multi-member LLCs are preferable whenever possible.

Multi-LLC Business Strategies: Liability Segregation

Multi-LLC planning strategies are not exclusive to LLCs alone. These same strategies may be used with limited partnerships or corporations. However, corporations don't have charging order protection, and limited partnerships don't have limited liability for the general partner, although we can compensate for this shortcoming by using an LLC as the general partner. Therefore, the following planning strategies are usually most effectively used with LLCs.

The 1st strategy is very simple: we put various assets into separate LLCs so as to segregate certain assets from the potential liability produced by other assets in. This is called "liability segregation" and is especially useful in protecting non-liability producing or "safe" assets, such as investments, from high-risk or "dangerous" assets, such as a vehicle or business that contracts with the public. If a vehicle or high-risk business is in one LLC, then, a lawsuit against that LLC will not threaten the assets in another LLC. Likewise, a lawsuit against an LLC's owner will not threaten assets in his LLC, and will not affect his interest in an LLC beyond the creditor possibly obtaining or foreclosing on a charging order. Figure 10.1 illustrates the concept of liability segregation.

FIGURE 10.1



Although a multi-LLC approach is effective, it is not without its drawbacks and vulnerabilities. First, multiple LLCs generally mean multiple tax returns, administrative costs, added complexity, and higher overall governmental fees (such as annual reports, or franchise taxes such as the infamous $800 minimum California LLC tax and fee levied on each LLC registered or doing business in California.)[224] Furthermore, although one LLC's assets are not exposed to liability arising from another LLC's liability, an LLC that is sued could still potentially lose all its assets to the creditor who is suing it. There are ways to overcome or minimize this weakness, including equity stripping (which is discussed briefly later in this chapter and more fully in Chapter 15), and also the strategy we discuss next.

A 3rd weakness is that multi-LLC strategies have a small chance of having their LLCs' veils pierced if they are structured incorrectly. This type of piercing does not involve a creditor being able to attach the assets of an entity's owners; rather it involves a creditor being able to disregard the segregation of liability between multiple entities. In other words, a creditor may be able to reach the assets of all related entities for the liability of one entity. Veil piercing in general is "an extreme measure, sparingly used",[225] and in most cases separate entities will not be treated as one for purposes of what a creditor may attach, however if there is an egregious act of bad faith, gross negligence, or fraud, then a judge may consider whether an alter ego argument is appropriate. In such an instance, the courts will consider the following:

- Commingling of funds and other assets between the entities
- The holding out by one entity that it is liable for the debts of the other
- Using entity one as a mere shell or conduit for the affairs of the other
- Failure to keep separate company records
- Identical equitable ownership in the two entities

- Using the same offices and employees
- Identical managers for each entity[226]

Keep in mind that a judge may use the above only as factors to help him decide if disregarding separate entities' limited liability is appropriate. Disregarding one or more of the above may not lead to a veil-piercing. However, when structuring multiple related entities, it is wise to avoid as much of the foregoing as possible. The first four criteria are especially damaging and may be easily avoided in almost all circumstances. The other criteria are often avoidable without too much trouble. For example, it is not hard to set up separate P.O. boxes for different entities. Two entities may have the same majority owner but different minority owners (perhaps the minority owners own as little as 1-5% in a company.) If there are 2 multi-member LLCs, then one member could manage entity A and the other could manage entity B. Structuring in this manner minimizes any excuses a creditor might use to make a veil-piercing argument in court.

Multi-LLC Business Strategies: Asset Shifting via Lease or Licensing Agreements

A 2nd multi-LLC strategy is called asset shifting. This involves shifting assets out of the company that would normally use those assets. For example, an LLC that runs a medical clinic[227] would normally own all the medical equipment used by the clinic. However, a malpractice or other suit against the clinic could allow a creditor to attach everything the clinic owns. Therefore, it's a good idea to leave as few assets in the clinic (or any other business) as possible. Merely placing these assets in separate LLCs is insufficient, since the clinic still needs to use the assets. Having one LLC use another's assets without fair compensation is grounds for disregarding the segregation of liability between the entities. However, if we place assets in a 2nd LLC and lease those assets to the 1st LLC we can achieve meaningful asset protection. The 2nd LLC only does business with the clinic, which means it has almost no chance of being sued. If the clinic is sued, then, it has little a creditor might seize. Just like your office building's landlord won't be sued if one of your employees sexually harasses another, the 2nd LLC won't be sued for the torts or delinquent debts of the 1st LLC.

Asset shifting works with almost any asset that can be leased to another company. Such assets may include real estate, vehicles, intellectual property and trademarks (which are licensed rather than leased), office furniture, and more. Just remember: these arrangements should look like a real-world transaction between two unrelated businesses. Therefore, if one company leases an office building to another, all the trappings of a standard lease agreement should be in place. There should be a signed lease agreement between the two entities and periodic, fair market value rental payments made. Precautions should always be in place so the segregation of liability between the entities will be respected by a judge.

Asset Shifting A/R with a Billing and Collection Company (BICOCO)

One hot topic amongst many companies, especially amongst professional service companies such as laws firms and medical practices, is the protection of accounts receivable (A/R). Many believe it difficult or impossible to shift A/R to another company, and therefore many companies seek to equity strip their A/R using costly and cumbersome financing arrangements. However, a billing and collection company or "BICOCO" (pronounced "bee-koh-koh") can shift this valuable asset with much less hassle. A BICOCO basically handles all the billing and collections of A/R for the company that deals with the public. BICOCOs are not exclusive to asset protection as they are not uncommon in the business world. A BICOCO lawfully siphons off profits from the company for the services it renders, whilst it pays the main operating company enough to cover its expenses. When combined with lease agreements, this strategy is very effective. This is because each company that leases assets to the main company may place a lien on whatever the main company receives from the BICOCO so as to ensure its lease agreement will be honored. These types of liens are standard practice in the business world. For example, in commercial lease agreements it is common for the landlord to place a "lessor's lien" on a tenant's asset to make sure the tenant keeps his end of the contract. This type of "obligation-based" lien does not require expensive interest payments on a debt that most debt-based liens require (such as a mortgage or other collateralized debt). It is merely added to an existing lease agreement between two entities, in order to secure the lease contract. If there is already a lease in effect, this is very easy to do.

In summary, excess profits are diverted to the BICOCO, and whatever the BICOCO pays to the main company is secured by a lien, with the lien holder being the lessor of one or more assets that are leased to the main company. Because this lien is in place before creditor threats arise, it has priority over any subsequent judgment liens. Be sure to read more about obligation-based liens in this book's chapter on equity stripping.

One of the best features of a BICOCO is it collects A/R directly from the public, yet provides none of the services the public has paid for. This means it has practically no exposure to liability from the main company's operations, however the main company never receives the asset until it is paid out from the BICOCO. *In other words, there are no fraudulent transfer issues when using a BICOCO.* The main company never owns the A/R, and thus there is never an issue of whether the main company transferred its A/R so as to thwart a creditor. Because fraudulent transfer rulings are the most common reason an asset protection plan fails, the BICOCO is a very powerful planning tool.

Just remember: structuring a multi-LLC strategy in a sloppy manner may lead to it failing in court. If two separate companies have the exact same owners, managers, and mailing addresses, with no separate accounting records or bank accounts, then they may be treated by a judge as the same entity. If this happens, the protection afforded a BICOCO, obligation-based lien, or any other arrangement will fail. Nonetheless a properly structured plan will provide very strong asset protection if implemented in a timely manner.

Shifting Employee Liability with a Professional Employment Organization (PEO)

One of the greatest liability risks for any business are the actions of its employees. After all, torts arise because a person does something wrong or fails to do something right. For a company, the only people that generate this liability are the company's principle managers or its employees, and often a company's managers are employees as well. One of the worst employee-based lawsuits in recent memory involved a Giants stadium concessionaire who sold alcohol to an already-inebriated person. The person drove home drunk and hit another vehicle, causing serious lifelong injury to the other vehicle's passengers. Who got the judgment against them? The drunk driver? No. The employee who sold the alcohol? No. The concession company who employed the concessionaire? Yes. The judgment was for $110 million.[228]

The company in this example could have avoided the liability if it had used a Professional Employment Organization (PEO, also known as Professional Staffing Companies, not to be confused with Temp Agencies that only furnish short-term employees). PEOs are common in the business world and are not commonly used for asset protection, although they are a great asset protection tool. Open any phone book and you will find a list of PEOs wanting your business. A PEO is like a payroll company, wherein they handle all payroll taxes and other withholding requirements, as well as administer pension plans and health benefits. However, unlike a payroll company, a PEO hires the employees as its own. The employees are then leased to the main operating company. Because the PEO is the employer rather than the main company, if the employee causes liability the PEO is the party liable for damages. This of course diverts liability away from the main company. We call such a strategy "risk shifting", because it shifts risk instead of assets away from the main company. A PEO of course should hold only enough assets to pay its business expenses. Therefore, if it is sued there are no significant assets at risk.

PEOs may also be helpful in diverting lawsuits brought forth by the employees themselves. If one employee sexually harasses another, the PEO is sued instead of the main company. Since the PEO hires and fires all employees, it is also liable for negligent hiring and negligent termination claims.

Shifting Risk with an LLC Management Company

The last section mentioned both principle managers and employees potentially causing great liability to a company if they commit an act of negligence, bad faith, or other misconduct. While PEOs can shift employee liability away from the main operating company, it does not protect a company from any tortuous acts of its management. Many individuals seeking asset protection are managers and owners of companies that do not wish to get sued personally in because of their business's activities. There are a few ways to mitigate this risk:

- If you manage a company, protect your personal wealth so that if you are sued, you will have substantially less wealth at risk.
- Buy officers and directors liability insurance.
- Buy an umbrella liability policy (this is usually an add-on to homeowner's insurance), which often only costs a few hundred dollars a year.
- Use an LLC management company to manage your company.

An LLC management company is basically an LLC that contracts to manage other businesses. An LLC management company may manage almost any type of business, and is very common in the business world. For example, property management companies often handle the landlord duties for an individual who owns rental real estate. Although not a guarantee, in the event of a lawsuit arising from mismanagement, liability is often diverted from the main operating company (such as an LLC that holds rental property) to the managing LLC. Furthermore, delegating the day-to-day management of one's business to managers other than oneself reduces one's risk of being personally sued for breaching a business contract or other tortuous business-related conduct. Although an individual must take a more "hands-off" approach if they wish to reduce their risk of being sued, the benefits for doing so often outweigh the drawbacks.

The Offshore LLC

Although this chapter focuses on domestic LLCs, we will briefly mention their offshore counterpart, the offshore LLC. Certain jurisdictions (most notably the island nations of Nevis-St. Kitts, more commonly referred to as Nevis) have passed LLC legislation that closely mimics U.S.-based LLC law. This means their laws will be familiar to a U.S. judge, which allows us to more confidently predict how he will treat them in a debtor-creditor situation.

Offshore LLCs are an often less expensive and, if structured correctly, even more effective alternative to the offshore trust. This is because offshore asset protection trusts typically have the grantor (who places assets into the trust) as the trust's beneficiary. Most states' laws do not allow such trusts to protect one's assets from their creditors; such a trust relies solely on the fact that the trust's grantor is (supposedly) unable to repatriate trust assets to the U.S. so a creditor may seize them. The offshore LLC may be structured so as to also raise the defense of its owner being unable to repatriate offshore assets, however it also benefits from charging order protection, meaning even if repatriation were possible, in most instances the member's creditor would not be allowed to attach those assets anyhow. This book's introductory chapter on offshore planning, along with the chapter entitled "Asset Protection a Judge Will Respect" explore how to correctly structure an offshore LLC for maximum asset protection.

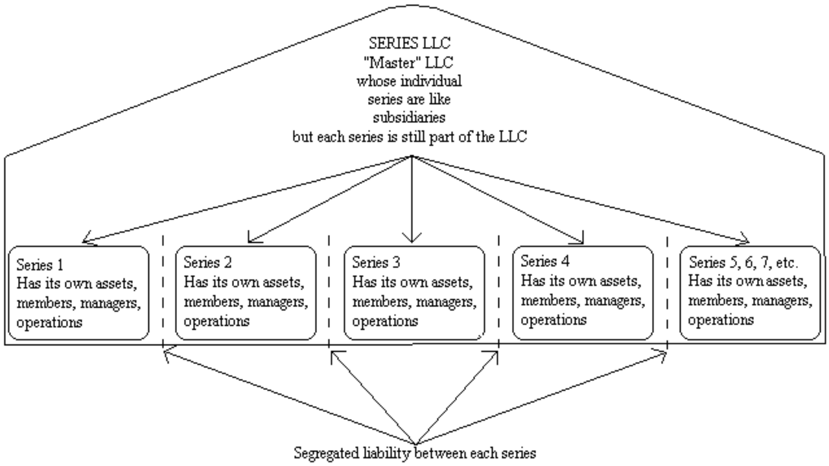
Like its domestic counterpart, an offshore LLC may elect to be disregarded from its owner for tax purposes. This allows it to sidestep the complicated withholding rules for an offshore structure that derives income from within the U.S.[229] An offshore LLC taxed as a partnership will usually not be subject to withholding requirements if it does not derive income from within the U.S., however there may be a withholding requirement if it has U.S.-source income.[230] Note that, unlike domestic LLCs, all offshore LLCs (even disregarded entities) must file an annual information return with the IRS,[231] with stiff penalties for failing to do so.

The Series LLC

At the time of this writing, eight states have passed series LLC legislation (Oklahoma, Nevada, Utah, Delaware, Iowa, Illinois, Tennessee, and Wisconsin), with several others considering such. The series LLC presents many exciting planning opportunities, however it is currently in the same situation now as normal LLCs found themselves in before the IRS had issued guidance on how they should be taxed. We'll discuss this tax uncertainty shortly.

The series LLC is like a normal LLC, with one important difference: it can have multiple individual "cells" or "series", each of which may have their own members and managers, and each of which enjoys segregated liability from the other series. In other words, a series LLC is like a normal LLC or corporation with subsidiaries, except that where normally subsidiaries would be different entities, each series of a series LLC is considered part of the LLC as a whole. Figure 10.2 illustrates the series LLC concept.

FIGURE 10.2



Series LLC Planning Opportunities

With the series LLC come tremendous planning opportunities. For example, if a single business has investments, real estate, and delivery vehicles, it would normally not be a good idea to place all these assets in a single entity. Liability arising from a high-risk asset (such as a delivery vehicle if it was involved in an accident) could jeopardize all of the company's assets. The conventional way of segregating safe assets away from the liability of dangerous assets is to set up multiple LLCs or other entities. The real estate might be placed in one LLC, the investments (a "safe" asset that has no potential to generate liability) are placed in another LLC, and the highest risk asset, the vehicles, are placed in another LLC. Even better, each vehicle or piece of real estate may be placed in a separate LLC. The disadvantage of using non-series LLCs is that each one comes with its own administrative and governmental costs. The more LLCs one uses, the more overall costs are. A series LLC allows us to achieve the benefits of traditional multi-LLC planning without the cumulative administrative/governmental costs of using multiple LLCs.

There may be some other advantages of a series LLC, as well. Adding or removing a series does not usually require additional filings with the LLC's Secretary of State's office, as different series are typically created and terminated by amending the company's operating agreement. This may be a great benefit to companies regularly need to add and remove subsidiaries, such as a venture capital firm.

Series LLCs may also be advantageous for companies that wish to merge. Instead of a traditional merger, the companies can form a series LLC; each company then pools its assets into a separate series. The rights and responsibilities of each company may be defined for each separate series. Other rights and responsibilities may be jointly shared in accordance with the series LLC's operating agreement.

Another possible benefit is the avoidance of extra administrative costs or transfer taxes associated with transferring an asset between two separate entities. These costs may be reduced or avoided if the same transfer is made between different series in a series LLC. After all, the transfer is occurring within a single entity, not between entities, so there may not be an actual "transfer" for tax or other purposes. Furthermore, pooling all of ones assets into an entity, instead of separating them between different entities, may make that entity more attractive to investors. A series LLC could accomplish this goal while still retaining a segregation of liability between assets in different series. This approach may even be superior to using an entity with subsidiaries, since the asset protection for an entity with subsidiaries may be inferior to that of a series LLC in certain situations. For example, even if a master LLC was set up with subsidiary LLCs (so that all assets are under the "umbrella" of the master LLC for the purpose of attracting investors), if a creditor sued the master LLC, it may be able to get a charging order against the subsidiary LLCs. What's worse, if the master LLC is the sole owner of its subsidiaries, then there may not be any charging order protection at all. With the series LLC, each series may, depending on the laws of the state wherein it is formed and/or operates, have a clear segregation of liability from the other series as well as from the master LLC.

Tax and Choice-of-Law Issues with the Series LLC

Notwithstanding the many potential benefits of the series LLC, there is much uncertainty regarding their use. The IRS has issued practically no guidance on how they should be taxed. In some instances this is not a problem. For example, if the membership of each series is identical, then the series LLC will almost certainly be treated as a single entity for tax purposes. If different series have different members, however, then the logical conclusion is each series would be treated as a subsidiary of the series LLC, and thus be required to file its own tax return. If the IRS does issue guidance along these lines, then a series LLC may not avoid as many administrative hassles as one might hope for.

State franchises taxes are another area of uncertainty. With the advent of the Delaware series LLC (the first state to allow such), some practitioners began forming series LLCs in California as a means of circumventing California's minimum $800 per LLC annual tax and fee. Unfortunately, these planners jumped the gun, as the FTB subsequently took the position that each series in a series LLC has to pay the tax.[232] What's worse, we'll shortly discuss how California case law may lead a judge to disregard the segregation of liability between each series. In other words, the case may very well be that Californians get the worst of both worlds with a series LLC: all the taxes of separate LLCs with none of the benefits! This is a prime example of how making an assumption regarding series LLC tax treatment may come back to haunt someone once official legal or tax guidance is finally given.

An even greater area of concern is whether each separate series will have segregated liability in states that have no series LLC legislation. As we discussed in this book's chapter on Corporations and Limited Liability Concepts, the court decided in *Butler v. Adoption Media, LLC*[233] that California law could be applied to a non-California LLC concerning matters of limited liability between the LLC and an unrelated 3rd party. To reiterate, the court stated:

> "Defendants argue that Arizona law applies because the [California limited liability company act] … provides for the application of the law of the state of organization (here, Arizona) to issues of liability between an LLC and its management and officers as well as to issues concerning the organization of the LLC. Cal. Corp.Code § 17450(a) ("The laws of the state ... under which a foreign limited liability company is organized shall govern its organization and internal affairs and the liability and authority of its managers and members.") The court finds, however, that § 17450(a) simply codifies the internal affairs doctrine, as applied to LLCs. In other words, § 17450(a) does not apply to disputes that include people or entities that are not part of the LLC." [Citations omitted].

While the *Butler* and related cases do not absolutely mean an LLC's series will not have segregated liability in a state without series LLC legislation, it does cast doubt on the matter. Nonetheless, since non-series LLC legislation has passed in all fifty states, if the segregation of liability between series fails, the LLC as a whole should still have limited liability. The bottom line: using a series LLC in a state that does not have series LLC legislation makes you a bit of a guinea pig. No one can say for sure how the series will be treated if challenged in such a state, although each series will probably be respected in a series LLC state. Nonetheless there are some things we can do so as to reinforce the limited liability of each individual series, which will be helpful in both series and non-series LLC states.

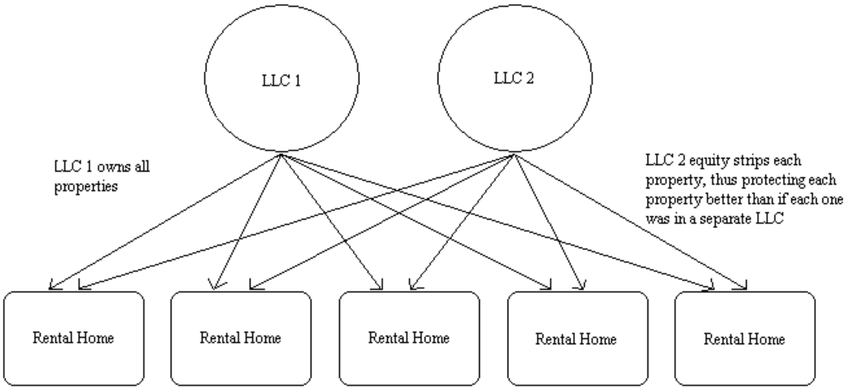
Operating a Series LLC so as to Reinforce the Segregation of Each Series

Even when using a series LLC in a state that allows for such by law, one should not assume that series protection will always prevail. Many of the same strategies we use for preserving charging order protection or the limited liability of each non-series LLC in a multi-LLC strategy can be applied to reinforce the limited liability of a series. This means that each series should have their own accounting records, bank accounts, and preferably their own mailing address (even if the separate addresses are merely different P.O. boxes.) The business operations of each series should be distinct and separate one from another. Furthermore, a series LLC should announce publicly it is a series LLC by stating such on its publicly filed Articles of Organization. Any contract the series enters into should designate that particular series, not just the LLC. For example, one would sign the contract as "ACME LLC, series 1" instead of merely ACME LLC. Furthermore, whenever possible a contract should include a provision that the individual series is the only part to the contract, and therefore that series only is bound to the contract as opposed to the LLC as a whole. Further language could be included that would in effect declare that only the managers of the series could be held liable for any torts, thus helping to keep liabilities of one series from personally attaching to the managers of other series.

Using Equity Stripping to Gain the Advantages of the Series LLC Without the Drawbacks

As we've discussed, multi-LLC strategies may have high administrative costs, and series LLCs, although less of a hassle, come with many uncertainties. Is there any way we can protect multiple types of assets in a way that doesn't involve several entities, and without the uncertainties of the series LLC? There is; enter equity stripping. Although equity stripping is an asset protection technique we discuss more fully in Chapter 15, we'll mention it here briefly. Essentially, equity stripping involves placing a lien or liens on one or more assets, encumbering the asset to at least 100% (or more) of its fair market value. Placing a lien on the asset effectively transfers that asset's equity to the lien holder, hence the term "equity stripping". More important, however, is the fact that the asset's equity is no longer available to creditors or anyone else besides the lien holder. Thus, even if a creditor sues an LLC that holds significant assets, if those assets are equity-stripped, a creditor cannot effectively attach them. Furthermore, a single debt or obligation can be secured by liens on several different assets. Herein lays the key to our alternative strategy: one LLC can hold all assets, and another LLC or other entity can equity strip them. In other words, we only need two entities at most to protect all of one's assets, even if the assets are extensive and diverse. Figure 10.3 illustrates this strategy in action.

FIGURE 10.3



Although the aforementioned strategy has many benefits, one should be aware that equity stripping may or may not be desirable for a number of reasons. This book's chapter on equity stripping more fully explains this strategy's pros and cons. Remember that each strategy mentioned in this book is only one of many tools in an asset protection planner's toolbox. In some situations there are tools that are more appropriate than equity stripping when meeting one's needs. Part of what separates the great planners from the mediocre ones is knowing when to use the right tool.

The DEMMLLC: A Multi-Member LLC that's Taxed Like a Single Member LLC

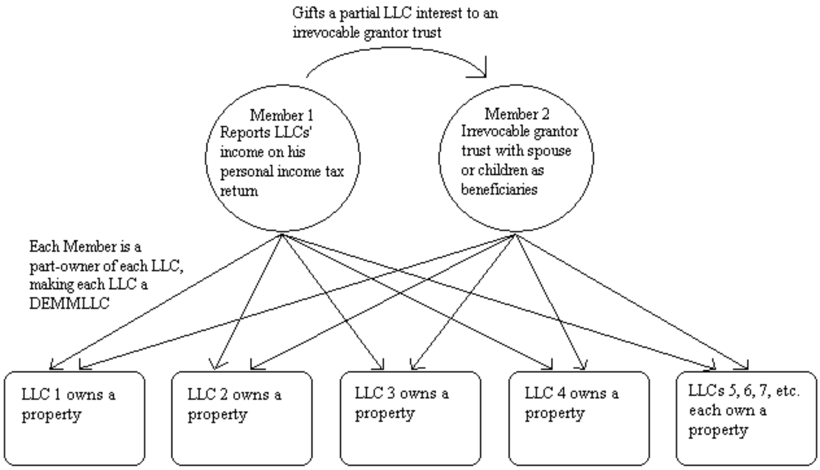
As previously mentioned, a single member LLC generally files no entity level income tax return.[234] This reduces administrative hassles, yet a multi-member LLC provides better asset protection. Thus we have an apparent dilemma: we seem to be forced to choose between ease of use and better protection. However, there is a way to get the best of both worlds. Enter the Disregarded Entity Multi-Member LLC (DEMMLLC). This is a multi-member LLC that, for tax purposes, is taxed as a single member LLC, with the IRS's blessing.[235]

A DEMMLLC is created by structuring an LLC so that, although it has more than one member, all underlying tax liability lies with a single individual. To do this, one uses an irrevocable grantor trust[236] or another single member LLC as an additional member. In the case of a grantor trust, the grantor is the same person as the original LLC's first member, however the fact that a trustee is now involved (who should have discretionary powers so as to hold voting rights within the LLC) makes the trust "count" for determining whether this LLC has the enhanced charging order protection of a multi-member LLC. In the case of using a second single member LLC, the member of this second LLC should be the same person as the first member of the first LLC. However, someone else should be the manager of this 2nd LLC. This manager, therefore, would also be able to have a 'vote' in regards to how the first LLC is run. Thus in both instances we have at least two people who have a say in how the LLC operates, yet only one person with any underlying tax liability. The question may be asked: which of these two approaches is best: using an irrevocable trust as the 2nd member or a 2nd single member LLC? We believe using a non-self-settled trust is the best approach, because this trust will have a beneficiary who is not the 1st member of the LLC. This means that if charging order protection was ignored, the trust beneficiary would be harmed by the creditor's attachment of LLC assets, which the trust and beneficiary relied upon to generate income. With a 2nd single member LLC, however, there is still only person actually involved — he just now happens to own 2 LLCs, with one being the 2nd member of the 1st LLC. Remember: it's always better to actually involve a 2nd natural breathing person as an equitable interest-holder somewhere along the line in an LLC or LP's structure. This person acts as an innocent 3rd party that a judge isn't willing to harm by allowing a creditor access to an entity's assets.

Using DEMMLLCs to Mimic the Series LLC, Without Series LLC Uncertainties

In what situations would a DEMMLLC be useful? One is example is if an individual owned multiple real properties and wished to put each one in an LLC, to insulate the properties from each other's liability. Setting up multiple LLCs that were taxed as partnerships would mean a partnership return would have to be filed for each company. If an individual owned 10 or 20 properties, the time and expense associated with filing these returns could be prohibitive. Not so with the DEMMLLC. As we see in Figure 10.4 below, a single LLC could hold each property, however only one tax return would be filed, regardless of how many entities there were. This is because only the LLC's owner for tax purposes files a return, since the individual DEMMLLCs have no filing requirement.

FIGURE 10.4


Gifts a partial LLC interest to an irrevocable grantor trust
Member 1
Reports LLCs' income on his personal income tax return
Member 2
Irrevocable grantor trust with spouse or children as beneficiaries
Each Member is a part-owner of each LLC, making each LLC a DEMMLLC
LLC 1 owns a property
LLC 2 owns a property
LLC 3 owns a property
LLC 4 owns a property
LLCs 5, 6, 7, etc. each own a property

CHAPTER ELEVEN

Trust Fundamentals

A Brief History of Trusts

The earliest roots of the modern trust concept probably derive from the "Waqf", which originated in the middle-East between the 7th and 9th century A.D.[237] The Waqf is very similar to the medieval English common law trust, and its concept was likely borrowed from Crusaders of the 12th and 13th century upon their return home.[238] In their absence, many of these Crusaders had deeded their land and other property to another who was to manage their estate in their absence. Unfortunately, upon their return many of the new owners refused to return the property. At the time, there existed no provision in English common law mandating the current property owner (in modern times known as the "legal owner") return the property to its rightful or "true" owner (now known as the "equitable owner"). The Crusaders' petitioned their King regarding this injustice, which the King deferred to his Lord Chancellor. The Chancellor had broad power to act accord to his conscience of what was right (which is now known as the legal concept of "equity"). Consequently, the Chancellor established a record of deciding in favor of the Crusaders. As a result, trust law developed from the decisions of the Chancellors' courts, also known as Courts of Chancery.

The Basic Trust Structure

The basic concept of a trust today is very similar to that of medieval England. A trust is essentially a contractual relationship, although the trust itself is oftentimes treated as a separate legal entity in much the same way a corporation or LLC is. The basic components of any trust are the grantor, trustee, beneficiary, trust corpus, and trust agreement. The grantor is the person who conveys property to the trustee. The grantor is also known as a creator, maker, trustor, or settlor. The trustee holds legal ownership of the property, and manages the property on behalf of the beneficiary. The trustee is thus a fiduciary who is given stewardship over trust property. Each of these parties may consist of one or more individuals, and they may be a natural person or a company or other artificial entity. The trust corpus (also known as the principal) is the property owned and managed by the trustee on behalf of the beneficiary, not including income that accumulates in the trust from the investment of the corpus. Finally, the trust agreement is the legal contract that names all parties to the trust (grantor, trustee, and beneficiary), enumerates trust property, and specifies the terms upon which the trustee shall manage the trust's corpus. It also sets forth what rights to use and enjoyment of the corpus each grantor or beneficiary has, and to what extent each grantor and beneficiary may influence or command the trustee's management of the trust.

Trust Objectives

The modern trust may have one or more of several objectives. These include probate avoidance, estate tax reduction or elimination, management of assets for another (such as a minor, or an incompetent or disabled person), asset protection, and financial privacy.

Probate is the court-supervised process of distributing a deceased person's (decedent's) wealth to his or her heirs as well as paying off the decedent's outstanding debts. Many people wish to avoid probate because it can take a long time, often up to 2 years, to complete. Furthermore, legal and administrative costs can be very high. It is not unheard of for a $1 million estate to incur $50,000 in legal and other related fees during probate. Probate avoidance is usually accomplished by transferring the bulk of one's assets to a trust. Because the trust now owns the property, upon the person's death those assets are no longer in the decedent's estate, although they may still be subject to estate taxes. With the trust owning the property instead of the decedent, trust assets may pass to heirs independent of probate, according to the trust's terms. We discuss probate avoidance in more detail in this book's chapter on estate planning trusts.

Estate tax reduction or elimination is the primary focus of many trusts. In Chapter 13 we'll discuss the basics of gift and estate taxes, but for now suffice it to say these taxes can be very heavy — up to 60%! Estate planners primarily use trusts to legally avoid these taxes. The Internal Revenue Code[239] (IRC) contains many rules governing the proper use of such trusts, and as a result these trusts are often, unsurprisingly, very complex. As a general rule, any trust that may be revoked or amended during the grantor's lifetime does not reduce estate tax liability. However, an irrevocable trust that is taxed separately from the grantor and his estate, wherein assets are gifted or sold to the trust, will often reduce estate tax liability if it is structured correctly. Furthermore, once those assets are transferred outside one's taxable estate, any appreciation in trust assets or trust income will be free of estate taxes, even if the transfer results in a taxable gift for the grantor. This "freezing" of estate tax liability against future growth or income of a trust asset is commonly referred to as an *estate freeze*.

The original purpose for trusts was to manage assets for those who are unable to competently do so themselves. This is a common purpose for trusts today, and modern trusts often accomplish this and other objectives simultaneously. For example, an irrevocable trust may be created to pass wealth to one's heirs free of probate, but it may also effect an estate freeze and thus reduce estate tax liability, as well as manage the assets for the heirs who lack the age and maturity to do so for themselves. Furthermore, the trust may protect the funds from creditors of both the grantor and the beneficiaries. The wealthy "trust fund babies" are a prime example of why such trusts are used. Wealth continues to the next generation, but the transfer is done via a trust so the wealth is not squandered by the beneficiary or his creditors. In a similar vein, other trusts are created to ensure a mentally or physically challenged individual is taken care of.

Asset protection may or may not be an achievable goal with a trust, depending on the type of trust and the grantor's circumstances. A revocable trust offers very little asset protection; if challenged, a judge typically orders the grantor to terminate the trust, or he may allow the creditor to seize trust assets outright.[240] A domestic trust where the grantor is also the beneficiary (also known as a "self-settled" trust) offers no asset protection in 42 of 50 states, as the laws of those states allow a grantor's creditor to attach any asset the grantor placed in such a trust.[241] The exception are the eight states that have passed Domestic Asset Protection Trust (DAPT) legislation,[242] however even these trust assets are vulnerable to creditor attachment until two to four years after the transfer (the duration where assets remain attachable depends on a particular state's statute of limitations.) Furthermore, these trusts are vulnerable in bankruptcy (as we'll discuss in the next chapter), and they are also vulnerable to creditors if the asset, trustee, and grantors are not all located in a pro-DAPT state. Depending on the circumstances, these shortcomings may or may not also extend to offshore asset protection trusts (OAPTs). We'll discuss DAPT and OAPT strengths and weaknesses in the following chapter.

With the foregoing in mind, using the correct trust in the correct situation may provide very substantial asset protection. However, trusts are most effective when their asset protection provisions are coupled with an estate planning or other valid purpose. The method of funding a trust may also reinforce or detract from its effectiveness as an asset protection vehicle.

Another advantage of trusts is financial privacy. Most trusts are not required to be registered with any government authority.[243] Compare this to a will, which is filed with the county recorder's office and available to the general public. Trusts have long been used as a privacy tool for grantors and beneficiaries. For example, if a house is titled in a trust, only the trustee's name appears on the title. However, in modern times where e-mails, phone calls, and financial transactions are all traceable, a trust's privacy should not be considered failsafe. Trusts give limited privacy at best; anyone who hires a private investigator will probably be able to find out who's behind a trust. This is why financial privacy in general, though beneficial, should *never* be the foundation of an asset protection plan.

Trust Terminology

Trust law frequently uses many terms to describe a trust's features. Knowing of trust terminology is essential to understanding trusts in general. This section explains the most common terms.

> ***Self-settled trusts*** are trusts where the grantor continues to enjoy benefit or use of trust assets to some extent, regardless of whether the grantor is a named beneficiary of the trust. The term is used to differentiate between self-settled and non-self-settled irrevocable trusts (or rather, trusts that have no asset protection and trusts that do), as most revocable trusts are self-settled during the grantor's lifetime provide no meaningful asset protection in any case. An example of a self-settled trust is a where a grantor transfers a home to a trust but continues to live in the home rent-free. Generally speaking, and not including states that allow DAPTs, to the extent a grantor retains use and enjoyment of an asset, the grantor's creditor may attach the asset. For example, a qualified personal trust (QPRT) is a trust where the grantor only retains the right to live in a home rent-free for a limited number of years. If the grantor is sued, a creditor may not be able to seize the home outright, but he could seize the right to live in the home. Perhaps the creditor could rent out the home thus creating an income stream to satisfy his judgment. Some trusts, especially Pure Trusts (which we discuss in the next chapter), include language that appears to not allow a grantor to benefit from or use trust assets. However, if the grantor actually uses or enjoys the asset, then the form (what the trust says) is overlooked by a judge, who will only rule according to the substance (what is actually happening) of the arrangement.

Non-self settled trusts are trusts where the grantor retains no control over trust assets, neither does he continue to benefit from trusts assets in any manner whatsoever. If a trust is both irrevocable and non-self-settled, then its assets are probably safe from creditors if they are transferred to the trust long before any specific creditor threat materializes or is anticipated. If a creditor threat arises before the trust is funded, then the manner of transfer to the trust will be very important in determining whether or not the transfer is fraudulent. If the transfer is fraudulent, of course, the trust will then fail unless the transfer is made to an offshore trust. Even then, an offshore trust may not protect against fraudulent transfer rulings, as we'll soon discuss.

Inter vivos means "during one's life" and includes all trusts created while the grantor is still alive. The revocable living trust, or simply living trust, is a very common estate planning tool whose primary objective is to avoid probate of the grantor's assets when he dies.

Testamentary trusts are trusts created upon the grantor's death. Testamentary trusts are far less common than they used to be, however they are sometimes still created, often according to the terms of one's will. Testamentary trusts generally don't reduce estate tax liability, nor do they keep assets out of probate.

Revocable trusts are trusts that may be amended or revoked (terminated) by the grantor. Living trusts are usually revocable. No revocable trust provides meaningful asset protection or estate tax reduction, although probate may be avoided.

Irrevocable trusts are trusts that may not be amended or revoked by the grantor. The grantor may retain an interest in trust assets, or some control over the assets, however an irrevocable trust will only completely protect trust assets from a grantor's creditor if the grantor retains no right to use or enjoy the asset, or receive proceeds from the sale of assets. Furthermore, control over an asset must be very limited or asset protection will not be achieved. For example, if the grantor retains the right to change the trust's beneficiaries, then a judge could order the grantor to make his creditor a trust beneficiary.

Domestic trusts are trusts sitused in the U.S. Both the trustee and trust assets reside in the U.S.

Offshore or foreign trusts are trusts sitused in a non-U.S. jurisdiction. If either the trustee or trust assets are located outside of the U.S. or its territories, then the trust is generally considered foreign, at least for tax purposes. Some offshore trusts hold assets in the U.S. with an offshore trustee, however in many (not all) situations both the trustee and trust property must be located offshore to achieve meaningful asset protection.

Grantor trusts are defined by § 671 of the Internal Revenue Code. A grantor trust is a trust wherein the grantor retains certain powers over the trust, which results in the trust being disregarded as separate from the owner for tax purposes (although trust assets are still deemed to not be legally owned by the grantor or beneficiaries.) Gifts from a grantor to his grantor trust are not subject to gift taxes, and all trust income is treated as if it were earned by the grantor. On the downside, grantor trust assets are considered part of the grantor's taxable estate when he dies. Grantor trusts do not generally apply for a tax ID number (EIN).[244] Although all revocable trusts are grantor trusts, not all irrevocable trusts are grantor trusts. For example, a trust could be irrevocable, but the grantor could reserve the right to direct the trustee to use trust funds to purchase or make payments on a life insurance policy that insures the life of the grantor or his spouse. Under § 677(a)(3) of the IRC, this would make this trust a grantor trust, even if the grantor retained no power to revoke, amend, or otherwise control the trustee or trust assets.

Non-grantor trusts are also defined by the IRC. They are trusts where the grantor retains no control over or beneficial enjoyment of trust assets. Non-grantor trusts should have an EIN and file their own tax returns, and taxes are paid either by the trust or the beneficiaries. A gift to a non-grantor trust is subject to gift taxes unless the gift qualifies for the $12,000 annual gift tax exclusion (this amount is $24,000 for married couples under the Internal Revenue Code's "split-gifting" rules.)[245] Another drawback of non-grantor trusts is the tax on trust income (over a marginal amount) is generally taxed at the highest income tax rate.[246]

Simple Trusts are non-grantor trusts that distribute all trust income to beneficiaries at least annually, do not distribute trust corpus, and do not have special provisions to contribute, use, or set aside trust assets for charity.

Complex Trusts are non-grantor trusts that do not meet the requirements of being a simple trust in a given tax year. Depending upon the trust's language and its operation from year to year, a trust may be taxed as a simple trust one year and a complex trust the next year. The terms "simple trust" and "complex trust" are defined in the IRC.[247] Complex trusts are taxed in a slightly different manner than simple trusts, but like simple trusts they get an income tax deduction for income distributed to beneficiaries, as well as a deduction for any amount contributed to charity.

Non-perpetual trusts are trusts that automatically terminate after a number of years. Most states require trusts to be non-perpetual. These laws mandate that a trust cannot last more than 21 years beyond the life of the last surviving beneficiary. This is known as the rule against perpetuities. Some jurisdictions, however, have abolished the rule against perpetuities and allow trusts to exist perpetually.

Perpetual or "dynasty" trusts are trusts that may last indefinitely. Only some jurisdictions allow dynasty trusts. Once an asset is outside of the grantor's taxable estate, it can be used to generate income for future heirs without the asset itself having to pass to heirs. This means the asset will never be subject to estate taxes upon the death of any heir or descendant of the grantor.[248] Consequently, dynasty trusts can be a powerful estate planning tool, although they may be subject, at least initially, to generation-skipping taxes.

Common law trusts are governed by common law. Common law, as used in the U.S., originated in England and is based on the precedent of the courts rather than legislative (statutory) laws. Since all states have now passed some sort of legislation governing trusts to some extent, one may argue a U.S.-based common law trust is a thing of the past.

Statutory trusts are generally trusts enumerated in the Internal Revenue Code. Statutory trusts are most often used to gain a specific tax benefit as specifically provided for under the IRC. Some states have also passed laws allowing for specific types of trusts, such as the Illinois land trust, Massachusetts business trust, or the Domestic Asset Protection Trust (DAPT). These trusts may also be considered statutory trusts.

Trust Remainder includes all assets to be distributed from the trust upon its termination. A remainder beneficiary is thus a beneficiary entitled to a portion of such distribution.

Some of the foregoing terms may be combined together in order to describe the characteristics of a particular trust. For example, an irrevocable, non-self-settled inter vivos grantor trust is a trust created while the grantor is still living, wherein the grantor retains no beneficial enjoyment or use of trust assets, pays all the taxes for trust income, and retains no power to revoke or amend the trust.

CHAPTER TWELVE

Trusts for Asset Protection

Asset Protection Provisions Used in Trusts

First and foremost, all trusts must be irrevocable to provide any meaningful asset protection. The grantor must give up beneficial use, enjoyment, and control of trust assets. We further caution that any trust whose trustee may be influenced by the grantor may not provide meaningful asset protection in all instances. The courts regularly scrutinize the relationship between the grantor and trustee to see if the trustee is indeed independent of the grantor, or is merely someone who holds legal title to assets while following the grantor's direction. If the grantor holds influence over the trustee, then the trust may fail to protect one's assets. As one judge succinctly stated:

> "…the query must be: is this a trust over which the beneficiary [who in this case is also the trust's grantor] lacks any control, such that the beneficiary is simply that and nothing more, and regardless of what she does or says, she lacks the power to repatriate these assets [out of the trust]? — or, does the beneficiary retain such control that she has the power vested in her… to repatriate the corpus? If she has such power, then this asset is no different than any other asset… Once the power of the person who is either the owner or the beneficiary of the asset to repatriate is established, the court can require that person to repatriate the funds."[249]

In light of the foregoing, the most solid trust will have an impartial third party (or, at least, a non-insider), such as a bank or professional trust company, as its trustee. Obviously, then, obtaining solid asset protection with a trust may be more costly and inconvenient than using an LLC or LP, wherein the manager's relationship to its owners is usually not an issue. A trust should also not be self-settled, with the limited exception of offshore trusts and properly structured trusts in pro-DAPT states. As we've stated previously, self-settled trusts do not provide asset protection in 42 of 50 states. For example, Texas Trust Code, §112.035(d) states:

> "If the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of his beneficial interest does not prevent his creditors from satisfying claims from his interest in the trust estate."

Even if one were to refer to common law, common law does not allow self-settled trusts to protect assets. This has been the norm since the Statute of Queen Elizabeth in 1571. Much like the abolishment of a trust's rule against perpetuities, such a trust will be protected from the grantor's creditors only if a state has passed specific legislation to provide for such.

Assuming a trust is irrevocable, not-self-settled (except in pro-DAPT states), and has an impartial 3rd party as a trustee, we must furthermore reinforce a trust against creditors with specific anti-creditor provisions. The right provisions also preclude the creditor from exercising any rights that the beneficiary may have to anticipate income, or any other powers of appointment (that is, the power to change who receives the trust's principal or income) that would weaken the beneficiary's protection.

The first important asset protection clause is the *spendthrift clause,* which directly protects the trust assets from the beneficiaries' creditors. Specifically, the anti-alienation clause prohibits the trustee from transferring trust assets to anyone other than the beneficiary, which, of course, includes creditors of the trust beneficiary(ies). The spendthrift or anti-alienation clause expressly precludes any party with an interest adverse to the beneficiary (a creditor, ex-spouse, etc.) from making a claim against either the beneficiaries' share of the trust principal or any income distributions.

The spendthrift clause will not in itself always provide absolute protection. For example, several states do not fully enforce spendthrift provisions, and a spendthrift clause may not fully protect trust assets if a beneficiary declares bankruptcy, files for divorce, or has certain delinquent tax debts. Also, it does not protect income distributions after they have been made. Furthermore, spendthrift provisions are often poorly drafted or not comprehensively interpreted. This may or may not be an issue, depending on state law. For example, Texas law states: "[a] declaration in a trust instrument that the interest of a beneficiary shall be held subject to a "spendthrift trust" is sufficient to restrain voluntary or involuntary alienation of the interest..."[250] In this instance, then, merely mentioning that the trust is a spendthrift trust is sufficient. Nonetheless, the level of protection afforded under the jurisdiction of many states is based on the trust agreement's language, which directly correlates to the skill of the drafter.

Another important protective measure is to grant the trustee maximum *discretionary* powers. For example, if a trust specifies that a beneficiary is to receive a trust distribution at age 25, the trust's drafter should also consider whether those distributions are safe if the beneficiary has a judgment creditor or a spouse planning divorce when the beneficiary reaches age 25. From an asset protection standpoint, a trustee would ideally have the right to withhold income and principal distributions that would otherwise be payable to the beneficiary, whenever the trustee believes the funds would be wasted or claimed by the beneficiary's creditors. The discretionary clause also prevents a wasteful beneficiary from depleting or wasting trust assets; which is especially important for grantors whose children are beneficiaries.

Although a child or other beneficiary may responsibly handle his or her inheritance, the same may not be true for the beneficiary's spouse. Discretionary and spendthrift provisions can therefore help to keep the trust principal intact if a beneficiary dies or divorces. The spendthrift and discretionary clauses help to protect trust assets from beneficiaries' creditors by allowing the trustee the authority to withhold payments to any beneficiary while under creditor attack. The beneficiary's creditor cannot force a trustee to distribute assets to the beneficiary. The creditor's remedy is to claim whatever payments are actually paid by the trustee and received by the beneficiary; however, a trustee can always directly pay third parties on behalf of a beneficiary.

While the spendthrift clause allows the trustee to withhold payments to a beneficiary with creditors, an *anti-alienation* clause goes further. It prohibits the trustee from distributing trust income or principal to anyone other than the named beneficiaries.

In addition to a trust's discretionary powers, *sprinkling* provisions may be added. Sprinkling provisions are gaining popularity for trusts that are expected to be in force for ten or more years, where the future income or tax situation for each beneficiary is uncertain. The trustee can then modify distributions from the trust through a 'sprinkling' provision that grants the trustee the authority to either disburse or retain principal and income for the duration of the trust, thus determining what each beneficiary receives and when.

The trust grantor is the one who specifies what criteria the trustee will follow when determining distributions, and the grantor may set minimum income distributions when the beneficiary is a spouse or dependent child. As with a discretionary clause, the sprinkling trust provides for greater asset protection provided the grantor retains no rights to modify or revoke the trust. Moreover, a beneficiary cannot be a trustee. Although legally permissible, the trust assets in such an instance would then become vulnerable to creditors of the trustee-beneficiary. A trustee who can distribute trust assets to himself as the beneficiary allows his creditors to stand in his place for purposes of forcing distributions of trust funds, which the creditor can then seize.

A simple example of how a trust that includes the aforementioned protective provisions works is through the example of a New York accountant client. Tom owned $600,000 in mutual funds that he wished to leave to his two adult children, Dan and Heather. Tom and his wife could live quite comfortably without these mutual funds, and he also wanted to save estate taxes as well as provide some security to his children. Tom, however, had concerns that his children would unwisely spend their inheritance. Tom's concerns were resolved by establishing an irrevocable trust, naming his local bank as the trustee. Tom expressed to the trust officer his distribution preferences, which were incorporated within the trust documents. Tom and his wife funded the trust with an additional $24,000 in mutual funds annually so that their gifts to the trust would be tax-free. Since the trust was irrevocable, neither Tom's nor his wife's future creditors could seize these funds. The trust's anti-alienation, spendthrift, and discretionary provisions also protected the trust funds from his children's poor spending habits, as well as from their own possible divorce or lawsuits.

Tom correctly foresaw that the trusts would have substantial value. He also could foresee the possibility of its vulnerability due to his children's own lifestyles. With the irrevocable trust, Tom fully protected his mutual funds from his own creditors, gifted them tax-free to his children, reduced his estate taxes, provided for his children's future (which he intended to do through his will or living trust), and simultaneously protected the trust funds from his children's creditors.

A final caution regarding asset protection trust provisions and creditors: although these clauses may be effective against non-government creditors and even state tax authorities, the IRS may ignore spendthrift provisions if a trust beneficiary owes back taxes. Likewise, this may also be the case with other federal agencies. The rationale allowing the IRS to ignore anti-creditor trust provisions that are otherwise upheld by courts is found in *Bank One Ohio Trust Co. v. U.S.*, an excerpt of which states:

> "The spendthrift provision… clearly imposed restraints on the alienation of [the beneficiary's] interest… as would be true in most states, these restraints on alienation are enforceable in Ohio… Under the great weight of federal authority, however, such restraints on alienation are not effective to prevent a federal tax lien from attaching… state-law restraints on the alienation of property rights created under the state law do not affect the status of such rights as 'property' or 'rights to property' within the meaning of those terms… A restraint on alienation …thus 'cannot serve to defeat the federal tax lien.'"[251]

Although it is rare for the IRS to attach a beneficiary's interest in a spendthrift trust, nonetheless this case serves as a warning that even a trust whose assets are otherwise protected may be ineffective against federal tax liens and levies. Contrast this with the LLC, whose assets the IRS has admitted it cannot attach if the LLC is structured and operated properly.[252] We examine why this is so in the chapter entitled "Asset Protection and the IRS".

Funding a Trust with Installment Notes (Including Self-Canceling Installment Notes (SCINs))

The Uniform Fraudulent Transfers Act (UFTA) makes certain transfers to trusts more vulnerable to fraudulent transfer rulings than if the same transfer were made to an LLC or limited partnership.[253] This is because transfers to a trust are often done as a gift. In contrast, a transfer to an LLC or LP involves an exchange of equivalent value, because the transferor typically receives a company interest equivalent to the value of his transfer. A transfer that involves an exchange of equivalent value has a reduced risk of being deemed fraudulent.

To avoid the fraudulent transfer vulnerability typical of trust funding, one may have a trust purchase assets for fair market value rather than accept the assets as a gift. This is most easily accomplished with a promissory installment note, which is a note the trust gives to the seller, wherein it promises to pay for the asset over time with interest. If the promissory note carries adequate interest (usually 5% or more; 7% or more is preferable if the note is unsecured), then a trust's issuance of a promissory note to pay for a purchase will be an exchange of equivalent value. In some instances, payments could then be "forgiven", tax free, by up to $12,000 per year, or $24,000 per year if the grantors are husband and wife, but for maximum asset protection this should only be done after the fraudulent transfer statute of limitations has expired. Payments may also be made from trust principal or with earnings accrued from investing trust assets. Such payments would then be akin to an annuity for the grantor, providing guaranteed income over the term of the note.

One popular method of funding a trust is with a *self-canceling installment note* (SCIN). An SCIN is like a normal promissory note that gradually pays off a debt, with one important difference: if the seller (the grantor) dies before the note is repaid, then the buyer (the trust) has no obligation to pay the note's remaining balance. In other words, the note "self-cancels" upon the seller's death. This type of note, of course, carries a greater risk of not being completely repaid, and therefore its interest rate should be markedly higher in accordance with the seller's actuarially determined life expectancy. In addition to reinforcing against a fraudulent transfer ruling, the SCIN avoids potential gift tax liability when transferring assets to a non-grantor trust. Furthermore, the SCIN transfers assets outside the grantor's taxable estate, thus freeing future asset growth from estate tax liability and, if the grantor dies before the note is fully repaid, then estate tax savings are realized in proportion to the note's unpaid balance. However, in order to avoid private annuity tax treatment, the note should be structured so as to complete the sale before the end of the seller's actuarially determined life expectancy.[254]

One last note of caution when using installment notes: although they do not allow a creditor to attach the trust's corpus, a creditor may seize the promissory note and thus attach payments as they are made. Therefore, any SCIN or other installment note should be transferred to an LLC or LP (usually as a contribution of capital) to mitigate this risk.

Offshore Asset Protection Trusts (OAPTs)

Offshore asset protection trusts (OAPTs) are probably the most readily identifiable asset protection tool. After all, an LLC is more often used to simply run a business than protect assets. OAPTs, however, are almost always created with asset protection as a primary goal. Nonetheless, not all offshore trusts are OAPTs. An OAPT is an irrevocable offshore trust that is self-settled, meaning the trust grantors are also trust beneficiaries. Non-self-settled offshore trusts therefore do not fall within the definition of an OAPT.

Another feature common to OAPTs is the provision for a trust "protector". Many clients have concerns about moving their assets to a foreign jurisdiction. These concerns may be compounded by the fact that they have to surrender control of these assets to a foreign trustee. To make sure the trustee does not do anything contrary to the wishes of the grantor, a protector is appointed. A protector is an individual who, depending on the language of the trust, may have the right to veto trustee actions, fire the trustee, and/or appoint a new trustee. The trust may also provide that certain actions may not be unilaterally performed by the trustee without first obtaining the protector's consent. Although sometimes a protector is a U.S. person, it's best if the protector is foreign so as not to be subject to a U.S. court order.

Because domestic self-settled trusts provide little or no asset protection in most states, planners began setting up trusts in certain foreign jurisdictions that guaranteed asset protection for self-settled trusts. Unfortunately, over time offshore trusts have developed a stigma that sometimes negatively affects their efficacy. There have been a small number of cases wherein the grantor was ordered by a court to repatriate assets back to the U.S., so their creditors could attach them.[255] The grantors claimed an inability to repatriate assets (this is called the "impossibility defense"), however the judge did not believe them, and thus they were incarcerated for civil contempt when they failed to comply with the repatriation order. As one judge put it, "[i]n the asset protection trust context…the burden on the party asserting an impossibility defense [to a civil contempt of court charge] will be particularly high because of the likelihood that any attempted compliance with the court's order will be merely a charade rather than a good faith effort to comply."[256] These cases usually involved a flawed trust structure, such as was the case in *FTC v. Affordable Media LLC*. In this case, the trust grantors retained the right (as trust protectors) to repatriate trust assets until they resigned as protectors shortly before their case was decided. Nonetheless, it would be irresponsible for any offshore planner to ignore the impact these cases undoubtedly have had.

The foregoing does not mean that OAPTs should never be used. To the contrary, they are often an important part of an asset protection program. However, our opinion is an OAPT should almost never be the only line of defense in an asset protection program. Furthermore, offshore trusts are best used when coupled with a valid estate planning purpose. This means, in turn, that the offshore trust is most effective when it is not self-settled, or at least some of the beneficial interest belongs to heirs rather than the grantor, or there are residual beneficiaries after the grantor's death. One advantage of offshore trusts is they may be used for tax savings for the grantor's heirs. A properly structured offshore trust will, upon the grantor's death, become an irrevocable trust not subject to U.S. taxation as long as it derives no U.S.-source income. In the correct jurisdiction, this trust may forever be free of U.S. income and estate taxes after the grantor's death (however beneficiaries are taxed on distributions from the trust when they receive them). If such a trust exists perpetually (a.k.a. a "dynasty trust", which we'll discuss in this book's chapter about estate planning trusts), these benefits may be substantial. Having such a purpose for an offshore trust, which is a unique non-asset protection benefit that no domestic trust could provide, will mitigate much of their stigma.

Despite the potential estate planning and other benefits an offshore trust may provide, one must be careful not to use a trust to save on income taxes. Almost all such tax-savings scenarios are actually considered tax-evasion schemes by the IRS. The Small Business Job Protection Act of 1996 restricted the tax benefits available to offshore trusts, by making it so that any transfer of assets by a U.S. person to a foreign trust would make that trust subject to the IRC's grantor tax rules.[257] This means the trust's grantor must pay taxes on all trust income worldwide as if that income was actually received by the grantor himself. The IRS and Congress have taken numerous steps to ensure that attempts to circumvent this rule would not be legally permissible.

In many cases there are other ways to gain the benefits of offshore planning without the stigma that accompanies offshore trusts. Some of these ways are also less costly. Using an offshore LLC, for example, may be a better and less expensive alternative. Not only is implementation usually less costly, offshore LLC management fees are typically substantially less than offshore annual trustee fees. Combining an offshore trust with an offshore LLC and/or foreign annuity, life insurance, or portfolio bond policy may also be a good idea. This book's chapter on offshore planning will discuss these options in greater detail. Be sure to also read the chapter "Asset Protection a Judge Will Respect" to learn how to counter the potential pitfalls that accompany a repatriation order.

Domestic Asset Protection Trusts (DAPTs)

Because of the rising popularity of OAPTs in the 1990's (before there was any adverse case law concerning such), a few U.S. states passed legislation that mimicked that found in OAPT jurisdictions. The result is the Domestic Asset Protection Trust (DAPT). At the time of this writing, eight states have passed DAPT legislation: Alaska, Delaware, Nevada, Rhode Island, South Dakota, Utah, Missouri, Oklahoma, Wyoming, and Tennessee.[258] Unfortunately, DAPTs may be less effective than OAPTs and should only be used in narrow circumstances. DAPT weaknesses include:

- DAPTs generally won't protect assets until two to four years, depending on state law, after they are transferred into the trust. A hidden or other transfer not publicly discoverable may leave a creditor's window of opportunity to challenge the transfer open even longer.[259]
- If the grantor, trustee, or trust assets are not all located in a DAPT state, then a creditor may be able to convince a judge to use non-DAPT law instead of the other state's DAPT law, which would defeat the asset protection a DAPT provides.[260]
- Like all domestic trusts, case law may allow the IRS to ignore spendthrift provisions and reach the corpus of a trust if any of its beneficiaries owes back taxes (but only to the extent that beneficiary has an interest in the trust's corpus).[261]
- Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), which made significant changes to the bankruptcy code, a transfer made to any self-settled spendthrift trust (i.e. a DAPT or OAPT) may be undone if the transfer was made within 10 (*ten!*) years of filing for bankruptcy (this is known as the 10 year clawback rule).[262]

Because there are usually better ways to protect assets, the DAPT should almost never be used if either a person or his assets reside in a non-DAPT state. Furthermore, because of the two to four year statute of limitations and the ten year bankruptcy clawback rule, DAPTs should only be used with caution in pro-DAPT states.

Notwithstanding the above, DAPTs are a statutorily-authorized tool that may be useful in some circumstances. This is because some assets may be hard to protect by other means; we are largely referring to a principal residence in states that have only a limited homestead exemption.[263] Equity stripping a personal residence works well, but equity stripping is not for everyone.[264] Even the best equity stripping programs are at least a little on the cumbersome side. On the other hand, if you purchase a home with only a 10-20% down payment, and the home is in a DAPT state, then a DAPT may be a viable strategy. By the time the mortgage is paid down to the where a home has enough equity to be attractive to creditors, it will probably have been in the trust beyond the required two to four year period. Furthermore, the limited homestead exemption may cover the initial exposed equity. Say, for example, a person buys a house in Nevada for $1,000,000, with a $100,000 (10%) down payment. Nevada's homestead exemption is $200,000. Since the first few years of mortgage payments are typically almost all interest, there will be very little equity exposed within the first four years (furthermore, a Nevada DAPT provides protection after only two years). Afterwards, the home is statutorily protected against lawsuits without the requirement for an ongoing equity stripping program. Even if one opts to equity strip for more complete protection, the equity stripping need last only until the DAPT's asset protection kicks in. Furthermore, equity stripping has the downside that all equity stripping programs will eventually terminate, usually within 20 years. A DAPT could last much longer if it's structured correctly. Also, if a DAPT only holds a personal residence and receives little or no income, then annual trustee fees should be very affordable.

A DAPT used in the foregoing scenario would be fairly simple, straightforward, and easy to set up.

Offshore Purpose Trusts

Some foreign jurisdictions allow for the "purpose" trust. A purpose trust is like a normal irrevocable trust, however there are no beneficiaries. Instead, the trust assets are used to accomplish the trust's stated purpose. In this respect, purpose trusts are similar to foundations. However, a foundation's purpose is generally restricted to meeting charitable, educational, religious, or other nonprofit goals. In contrast, purpose trusts may have *any* purpose. This greater flexibility makes the purpose trust much more useful to the asset protection planner. For example, a purpose trust's purpose may be to simply hold stock in an offshore IBC, or to own an offshore LLC. Such an arrangement is useful if the trust holds the stock but never receives distributions. In other words, if a company operates so that all profits are expensed out to contractors (who, if it weren't for the purpose trust, would otherwise own the company) then a purpose trust could be a valuable tool.

Using a purpose trust to own a company in such a manner can be very useful. After all, if there are no beneficiaries, then who really "owns" the company? If a person has no ownership interest in a company whatsoever, then it will be difficult for a creditor to attach the assets in that company, or to attach distributions made from the company. To illustrate this point, let's examine the following scenarios:

> SCENARIO 1: An individual places $10 million in an OAPT. A creditor subsequently obtains a judgment against him. Whether the transfer into the trust was fraudulent is irrelevant in most states, since almost all states (even pro-DAPT states) allow a creditor to attach assets in a self-settled offshore trust regardless of when the transfer was made (pro-DAPT states allow self-settled trusts to protect assets *only* if the trustee is located in that state, meaning an OAPT probably could *not* benefit from DAPT legislation even if the grantor resided in a pro-DAPT state).[265] Therefore, the only hurdle a creditor has to clear is the debtor's argument that he lacks the ability to repatriate offshore assets. If this obstacle is overcome, then the plan fails.

> SCENARIO 2: An individual places $10 million in a multi-member offshore LLC, with offshore management. Management may only be changed by unanimous consent of all members. The individual receives a 99% interest in the LLC in exchange for his $10 million contribution. The LLC is properly run with a valid business purpose. A creditor subsequently obtains a judgment against him. If the initial transfer is deemed fraudulent, then like in Scenario 1 the creditor could argue the assets should be repatriated (there are ways to minimize the likelihood of a fraudulent transfer ruling, or make the transfer not voidable under U.S. law even if the transfer was fraudulent, but for the sake of brevity we won't discuss these ways here.) However, in all other cases our offshore LLC will fare better than the OAPT in Scenario 1. Unlike with the OAPT, the creditor has no rights to LLC assets; U.S. law effectively places them out of his reach. Nonetheless, the creditor may obtain the right to receive distributions from the LLC via a charging order. The manager could withhold distributions, so the creditor would receive nothing, but the debtor would likewise not be able to access LLC assets. The debtor may try and work for the LLC and receive compensation, however a judge may consider this as an attempt to thwart the charging order and declare the payments a de facto distribution attachable by the creditor. Future distributions not made directly to the creditor (or not given by the debtor to the creditor when he receives them) may lead a court to find the debtor in contempt, which could result in his incarceration.[266] Therefore, if the debtor needs to access LLC funds for cost of living or other expenses, he may find himself in a difficult situation until the creditor threat resolves.

> SCENARIO 3: This scenario is the same as Scenario 2, except the individual places his 99% offshore LLC interest in an irrevocable offshore purpose trust, which is taxed as a grantor trust for federal tax purposes. He then works as a bona fide consultant for the LLC and is compensated accordingly. This arrangement would be treated the same as scenario 2 if the initial transfer was fraudulent. However, barring fraudulent transfer issues this arrangement is superior to that of scenario 2, because the debtor does not own the LLC. Therefore, the creditor could not get a charging order against the LLC membership interest. *This allows the debtor to continue to receive compensation from the LLC, even while he is under creditor attack.* Furthermore, it will be very difficult for the creditor to attach payments as they're made from the offshore LLC, as long as the payments are not extraordinarily large and are quickly used on cost of living and other expenses. (The creditor might conceivably drain one or two payments from a domestic bank account if he's quick to do so before the funds are spent or otherwise withdrawn, but the amounts seized will be very small in relation to the total LLC assets.) Furthermore, the creditor could not argue the payments are de facto distributions from the LLC, subject to a charging order, since the debtor is not a member of the LLC like he is in Scenario 2.
>
> One may think a standard OAPT could be used in lieu of a purpose trust under this scenario, but doing so will not be as effective, since an OAPT is self-settled, and thus subject to creditor attachment. This means an OAPT may not prevent a judge from granting a charging order, and regardless of whether or not the offshore manager is subject to the order, as long as the debtor remains in the U.S. he is subject to the court and may find himself in the same civil contempt situation described in Scenario 2. In contrast, because a purpose trust has no beneficiaries, it is not self-settled and therefore is not exposed to the vulnerabilities inherent in OAPTs.

Despite the advantages of purpose trusts, for some the arrangement in Scenario 2 is preferable. It may not be feasible for a client to perform actual services for an offshore LLC. If a client merely pretended to render such services, the charade could be exposed and subsequently deemed a sham. Accordingly, Scenario 3 is only appropriate if the services are actually rendered. Furthermore, Scenario 2 is the simpler of the two structures. If an individual doesn't mind the possibility of his assets being locked up while he's under creditor attack (so long as the creditor never gets them), then Scenario 2 will meet his needs with lower setup and maintenance costs. For yet another client, a combination of an OAPT with an offshore LLC may be best. Such may be preferable if the client wants maximum protection but is unable or unwilling to work for the LLC in order to expense out its profits.

Purpose Trusts are Generally Preferable to Foundations for Asset Protection

Some asset protection planners attempt to mimic the benefits of a purpose trust by using a domestic or foreign foundation. We do not recommend this unless the foundation has a bona fide charitable or other nonprofit purpose. Remember one of the most important maxims of asset protection: a structure's substance (what it's actually being used for) should always match its form (what the governing documents say it's being used for). If a creditor can prove the foundation has no actual charitable or other proper purpose, then a court may disregard it as a sham. Purpose trusts are much more flexible and do not have this problem.

Foundations may have other drawbacks as well. Under U.S. law, the limits of private foundations are defined in the Internal Revenue Code.[267] Foundations, including even certain foreign foundations, are subject to various federal excise taxes[268] and complex regulations and restrictions,[269] making their administration rather unwieldy when compared to an offshore grantor trust. Even foreign foundations in relatively foundation-friendly jurisdictions, such as Panama, have requirements that tend to make them more cumbersome than a typical purpose trust or OAPT.

Illinois Land Trusts

Although the land trust concept originated in Illinois, and are only statutorily authorized in 5 other states, land trusts are used nationwide. Land trusts are generally revocable as well as self-settled. Furthermore, the trustee typically has no discretionary powers, meaning he can only jump when the settlor tells him to, and then only as high as the settlor permits.

Land trusts are attractive to real estate investors for two reasons. The first reason is land trusts provide privacy, so that the settlor's name doesn't personally appear on dozens of properties at the county recorder's office. This helps the settler keep a low profile so as to reduce his chance of appearing as a "deep pocket" litigation magnet.

The second reason is that land trusts convert a person's ownership interest from a real property interest to a personal property interest. This is because the settlor becomes a beneficiary of the trust (which interest is personal property) rather than owning the real estate outright. Converting ownership from a real property interest to personal property may provide the following benefits:

- Interests in the land trust may be transferred quickly and privately via a notarized trust amendment — there is no need to record a deed. We might further note that a deed transfer in some states (such as

California) may trigger a tax reassessment of the property, which in turn may lead to higher property taxes. Using a land trust to avoid deed transfers will avoid this.

- Judgment liens or tax liens against a beneficiary or settlor don't automatically attach to trust assets, even if the trust is self-settled. A creditor could challenge the trust and then obtain a court order allowing him to attach the debtor's share of trust assets, but this takes time and effort. Therefore, to this extent a land trust, like all self-settled trusts, offers some minimal asset protection.
- For large development projects with multiple partners, the project won't be halted if a partner dies, gets divorced, becomes incapacitated, etc.
- If a rental property is held in a land trust and a tenant sues, the trustee (who would more directly manage the property) is more likely to be liable for damages than the settlors or beneficiaries. Using a trustee of only modest or moderate wealth would of course tend to lead to a lesser settlement than if a deep pocket settlor or beneficiary were sued (the trustee could of course be indemnified under the trust agreement.)

While land trusts certainly have their uses, by themselves they provide little asset protection, and therefore should only be used in combination with other, more asset-protected entities (LLC, etc.) if effective asset protection is desired.

Massachusetts Business Trusts (a.k.a. Pure Trusts, Common Law Trusts, and Contract Trusts)

The term "Pure Trust" is actually a misnomer, since Pure Trusts are more akin to a quasi-corporate structure. However, since the trust is not an actual corporation, it is not guaranteed limited liability under the laws of most states.[270] Pure Trusts differ from their traditional counterparts because they have no beneficiaries. Instead, they have certificates or units of beneficial interest, which are similar to corporate stock. These trusts may also have Exchangors (someone other than the grantor who funds the trust) and managers (usually the trust's grantors) who, subject to the Trustee's direction and supervision, may manage trust assets.

While not on their face a fraudulent arrangement, Massachusetts Business Trusts have earned quite a bad reputation over the last several years. They are also known under the aliases Pure Trust (their most common alias), Unincorporated Business Organization (UBO), Common Law Trust, and Contract Trust. Some fancier names include Common Law Trust Organizations (COLATOS) and Foreign Common Law Trust Organizations (FORCOLATOS).

The reason for these trusts' bad reputations is they are promoted by various scam artists as a way to legally avoid paying income taxes as well as provide asset protection and estate tax savings. Unfortunately for those duped into using Pure Trusts, the IRS takes a contrary position and considers the Pure Trust to be a tax evasion scheme.[271] Pure Trusts are not nearly as pervasive now as they were in the 90's and early 2000's, due to the fact that the IRS has been very aggressive in shutting down and even indicting Pure Trust promoters, many of whom are now enjoying extended mandatory vacations in various federal penitentiaries nationwide.

The usual Pure Trust arrangement has the grantor retain de facto control over trust assets (usually as a "manager" working under the trustee's supervision), even though the language of the trust may seek to cloud this fact by appointing someone other than the grantor as trustee. The grantor is also usually the beneficial unit (stock) holder, which essentially makes the Pure Trust a self-settled grantor trust. As we know from our discussions earlier in this chapter, self-settled trusts, or a trust over which the grantor retains too much control, provide no asset protection. Furthermore, a grantor trust (other than an intentionally defective grantor trust, which we discuss in the next chapter) does not reduce estate tax liability, and all of a grantor trust's income taxes are paid by the grantor rather than the trust itself.

There are numerous tax court decisions that rule Pure Trusts to be shams, but perhaps the most enlightening case is *Ruby Mountain Trust v. Montana Department of Revenue*, which examines the Pure Trust structure in depth.[273] This case states, among other things, that Pure Trusts are "void under Montana law, [and] any transfer of property to the Trust is likewise void. The Trust must be disregarded for Montana tax purposes." The court also notes that Pure Trusts are regarded as shams and abusive tax shelters under federal law.

In summary, we do not recommend Pure Trusts, or their kin, to any individual, at any time, in any circumstance, for any reason whatsoever.

CHAPTER THIRTEEN

Trusts for Estate Planning

The most common use of trusts is for estate planning. Since the best asset protection planners know that asset protection works best when coupled with other legitimate purposes, using a trust to achieve both asset protection and estate planning results in a more formidable overall barrier against creditor threats, while efficiently meeting multiple objectives with a single strategy. After giving a primer on gift, estate, and generation skipping taxes, the rest of this chapter will be dedicated to summarily describing each of the most common estate planning trusts. We'll also briefly outline what level of asset protection each type of trust may provide. It is not our objective to exhaustively review all estate planning trusts and how they will be treated in every situation, as doing so could fill a separate book in and of itself. Instead, this chapter intends to identify the major trust strategies available and what benefits and possible drawbacks each one generally provides. A competent estate planner should then be contacted in order to make a final determination as to a strategy's viability for an individual's particular circumstances.

A Primer on Gift and Estate Taxes[274]

When a U.S. citizen dies, the money and other property he leaves behind is called his estate. His estate will have to pay federal estate taxes if its worth exceeds a certain amount. The government gives an automatic estate tax credit, however the amount of this credit varies from year to year. In 2008, a credit is given on the first $780,800 in taxes due, which would be the amount due if an estate was worth $2 million. This means the first $2 million in an estate will not be taxed if a person dies in 2008. We call this the exclusion amount, or the amount of an estate not subject to estate taxes. In 2009, the exclusion amount increases to $3.5 million. In 2010, there will be no estate tax, regardless of the estate's value, however from 2011 on the exclusion amount goes down to $1 million. Therefore, if a person dies in 2008, his estate is taxed only to the extent it's value exceeds $2 million, but if that person dies in 2011 or later, his estate is taxed to the extent it exceeds $1 million. At the time of this writing, the maximum estate tax is 45%, but in 2011 the tax progresses up to a maximum of 55% on wealth in the estate over the $1 million exclusion amount. (To simplify our discussion, for the remainder of this chapter we will consider the estate tax exclusion amount to be $1 million unless we note otherwise.) Note that in addition to federal estate taxes, there may also be state inheritance taxes due depending on a person's state of residence. Because these taxes are so high, estate planners have devised many ways, most often through the use of trusts, to legally reduce estate tax liability.

At first glance, avoiding the estate tax appears easy: just gift away all your assets before you die. Unfortunately, things are not so simple, as the federal government has also created the gift tax. The primary purpose of the gift tax is to prevent people from avoiding estate taxes by making gifts. Like the estate tax, the gift tax also has an automatic credit, which is permanently reduced by each taxable gift made over a person's lifetime. The gift giver (called the *donor*) does not have to pay a tax on taxable gifts while there is a credit remaining, but once that credit is gone, taxes will henceforth be due on taxable gifts. The gift and estate tax are tied together, or unified. This means that if gifts are made so as to be subject to the gift tax, these gifts will reduce the credit applicable to gift taxes as well as to estate taxes. Because a taxable gift reduces the credit on both gift and estate taxes, the estate and gift tax credits are collectively called the *unified credit*.

To further complicate matters, the lifetime gift tax credit and the estate tax credit are not always the same. For example, in 2008 the estate tax credit is $780,800, resulting in a $2 million exclusion amount, but the gift tax credit is only $345,800, resulting in a $1 million exclusion amount. While there is no estate tax in 2010, there is still a gift tax. The gift tax credit and estate tax credit are both $345,800 from 2011 on, however. The effects of these credits are illustrated in the following example:

> Joe has made no taxable gifts in his lifetime until 2002, when he makes a taxable gift of $250,000. He makes another taxable gift of $1 million in 2006. He dies in 2008. At the time of his death, his estate is valued at $250,000. Although Joe owes no estate tax, because his estate combined with the total gifts he made during his lifetime is only $1.5 million

> (which is less than the 2008 estate tax exemption of $2 million), he will owe gift taxes in 2006, because his $1 million gift in 2006, when added cumulatively to all other lifetime gifts, exceeds his $1 million lifetime exclusion on gift taxes by $250,000.

Fortunately, the U.S. government allows some leeway with taxable gifts. A husband and wife may make unlimited tax free gifts between each other. An individual may also give up to $12,000 to any other person (or $12,000 each to as many people as he wishes, no matter how many) each year without reducing his lifetime gift tax credit.[275] This is called the *annual gift tax exclusion* or simply the *annual exclusion*. In fact, there are no gift tax consequences whatsoever to the gift, as long as it is less than the annual exclusion amount. Furthermore, the receiver (called the *donee*) of the gift does not have to pay income taxes. Only charitable gifts are tax deductible by the donor, however.

A husband and wife may combine their annual exclusions so that they may collectively gift $24,000 per year per person tax-free.[276] This is called a *split gift*. Note that the $12,000 annual exclusion or $24,000 combined split gift exclusion is only tax free if the gift is a gift of a present interest. Gifts of future interests are taxable no matter how small the gift is. Later in this chapter the section on Children's Trusts and Crummey Trusts discusses the difference between a gift of present interest and a gift of future interests.

Generation Skipping Taxes

As if estate and gift taxes weren't complex enough already, the U.S. government has decided to throw generation skipping taxes (GST) into the mix. Essentially, generation skipping taxes are levied on transfers made to someone at least two generations younger than the transferor, or, if the transferee is not a family member, the tax will apply if the transferee is more than 37.5 years younger than the transferor.[277] The GST rate is the highest current estate tax rate.[278] This tax is levied independent of estate and gift taxes, and its purpose is to nullify the tax savings one would realize by gifting assets to a grandchild rather than a child. In other words, Congress wants to make sure each generation is subject to some type of estate tax. Fortunately, there are some exemptions available to the GST. There is a lifetime exclusion of $2 million from GS taxes, and $12,000 annual gifts that would otherwise be subject to the GST are exempt if the transfer is an outright transfer (if the transfer is made via a trust, the transfer must meet certain other criteria in order to benefit from the $12,000 annual exclusion).[279]

The good news regarding the $2 million GST exemption is once it is allocated towards a particular transfer, that transfer (to the extent it is covered by the exemption) will never again be subject to GST. For example, if an individual makes a transfer valued at $1 million to an irrevocable trust and allocates $1 million of his lifetime GST exclusion to the transfer, then that $1 million will never again be subject to GST, no matter how many generations it passes to or how much the asset appreciates or receives a return on investment. When combined with a dynasty trust (which we discuss near the end of this chapter), we thus have opportunities for placing assets forever outside the reach of gift, estate, and GST taxes.

Now that we understand the fundamentals of gift, estate, and generation skipping taxes (which we collectively call *transfer taxes*) we can more thoroughly understand how the following trusts are used in an estate planning context.

Living Trusts

The most common trust is the living trust, which is also known as the Family Trust, Loving Trust, or Revocable Inter Vivos Trust. As mentioned previously, the living trust's primary goal is to avoid probate of the grantor's assets when he or she dies, as well as provide for a means of managing the grantor's assets if the grantor becomes incapacitated.*280* Avoiding the time and hassle of the court-supervised process of distributing a deceased person's (decedent's) assets to their heirs may sound desirable, but are living trusts for everyone? The answer depends on the decedent's state of residence and the size of their estate. Some states, such as California, Delaware, Florida, and New York, have a relatively long and expensive probate process. However, other states, such as North Carolina, have a streamlined process. A small, simple estate in a state such as North Carolina may be inexpensively settled in as little as two to four weeks. However, probate of a more complex, large estate in a state such as California could drag out for a couple years, and legal and other costs could reach into the hundreds of thousands of dollars. Perhaps one drawback of probate that's universal to all states is the fact that anyone who wants to may access the probate records (including a list of estate assets) during probate.

There are also assets that avoid probate even without the use of a living trust. Such assets include:

- Property held as tenants by the entirety (TBE) or as joint tenants with right of survivorship (JTWROS). Full ownership automatically passes to the surviving owner. We discuss these ownership types more thoroughly in Chapter 7.
- Payable on Death (POD) bank accounts, which are available in several but not all states. Upon the owner's death, proceeds go directly to the named beneficiary, bypassing probate. The beneficiary may not access funds before the owner's death, neither need he be aware of the account prior to the owner's death. These accounts are also known as *Totten Trusts*.[281]

- Transfer on Death (TOD) securities, also available in several states. Securities are transferred on death if these securities are registered appropriately, and the beneficiary provides a certified death certificate and a signature guarantee.
- Life insurance proceeds with a named beneficiary; however probate is not bypassed if the beneficiary is the estate.
- Retirement plans with a named beneficiary, unless the beneficiary is the estate.

If an individual has had multiple marriages (especially if there are different children from different marriages), an estate over $500,000 in value, property located in multiple states, or a desire for privacy, then a living trust is probably a good idea.

As mentioned previously, living trusts are created during the grantor's lifetime, and the trust may be amended or revoked by the grantor anytime before he dies. The grantor thus retains complete control over trust assets during his lifetime, as well as the ability to receive as much income from the trust as he wishes. Oftentimes the grantor is the trust's trustee.

Because the grantor retains complete control over trust assets, any gifts made to the trust are gift tax free. However, there is a downside to retaining such control over a trust. First, any assets held in a living trust are included in the grantor's estate for the purposes of calculating estate tax liability even though the assets are not included in the estate for probate purposes. Furthermore, living trusts provide very little asset protection, as it is standard procedure for a judge to order the grantor to revoke the trust so that all assets revert back to his ownership, thus becoming subject to creditor attachment. Remember: a creditor of a grantor can control or access trust assets to the same extent the grantor can.

Upon the grantor's death the trust becomes irrevocable, and if the grantor was trustee then a new trustee is appointed in accordance with the trust. Usually a living trust includes a list of successor trustees for this very occasion. Upon the grantor's death, trust assets are normally distributed to heirs according to the provisions of the trust. However, this is not always the case. Some assets may be held in trust if the beneficiaries are still minors. Perhaps the assets are not distributed until the heirs are even older, or perhaps certain beneficiaries only receive income from the trust while it remains in force. Because trusts can be drafted in any manner so as to meet the grantor's needs, there will usually be some variation between trusts, even if they are the same type of trust. This flexibility is what gives trusts much of their power. If an heir is mentally challenged or otherwise disabled, for example, the trust could make sure that heir's needs are met even after the grantor dies.

Some living trusts contain provisions that will cause the creation of other trusts, or sub-trusts, upon some triggering event, usually the grantor's death. Credit shelter trusts (discussed later) are often created in such a manner.

Children's Trusts (Including Crummey Trusts)

Some parents wish to allocate specific assets to their children in case the parents die or become incapacitated, while at the same time reducing their taxable estate. These needs are often met by a *children's trust*. A children's trust is an irrevocable non-grantor trust, and thus a parent loses the right to control or benefit from trust assets. However, any gift made to the trust is transferred outside the parent's taxable estate. The usual strategy with these trusts is to create one trust per child and for each spouse to make a split gift of up to $24,000 to each trust each year. In a correctly structured trust, the gift will reduce the parents' taxable estate and thus reduce their future estate tax liability. Growth of trust assets also occurs outside the taxable estate, thus compounding future savings. Over time, these savings may be substantial. For example, if a husband and wife had three young children, they could set up a trust for each child and then make tax free gifts to each trust totaling $72,000 per year. If each trust realized a 10% annual return through investing its corpus, then over a 10 year period the combined trust assets would be $1,262,244. At a 55% maximum estate tax rate, tax savings would thus be $694,234.

Note that not all gifts to all trusts qualify for the annual gift tax exclusion. For the gift to qualify, the gift must be a present interest to its receiver (called the *donee*), meaning the donee must be able to immediately enjoy the gift. If the donee cannot immediately enjoy the gift, then the gift is a future interest and the $12,000 annual gift tax exclusion cannot be realized (meaning the gift will not be tax free). This puts us in a quandary in regards to making donations to trusts. If a child doesn't have access to trust assets, then no annual exclusion is available. However, many parents don't wish their children to have unfettered access to trust assets, for fear they may squander their inheritance. The solution is the Crummey Trust.

A Crummey Trust is a trust that allows a child to withdraw trust assets during a brief window of time each year. This trust is based on the case *Crummey v. IRS*.[282] The court decided that if a child had the right to withdraw trust assets at least part of the year, then any gift to the trust is a gift of present interests which would benefit from the $12,000 annual gift tax exclusion. Technically this window of time could be as little as one day per year, but subsequent IRS rulings regarding Crummey Trusts[283] have led most planners to play it safe by giving beneficiaries a 30 day window in which to withdraw assets. We further caution that the IRS takes the position that an individual must be an actual income or remainder beneficiary of the trust. The mere right to withdraw trust assets without an actual beneficial interest in the trust may lead to an IRS challenge. Furthermore, any implicit agreement that the beneficiaries shouldn't withdraw trust assets, even though they're technically allowed to do so, could trigger an IRS challenge.[284] The beneficiaries must also retain the right to withdraw all accumulated trust assets, except assets that are less than or equal to $5,000 or 5% (whichever is greater) of all gifts made to the trust each year over the trust's lifetime. The example in Figure 13.1 illustrates how this "5 by 5" lapse of withdrawal rights works. For simplicity's sake, this trust shall be considered to have only 1 grantor and 1 beneficiary, with zero growth of trust assets.

FIGURE 13.1 — 5 BY 5 RULE EXAMPLE

Year of Trust's Existence	Cash Value of Gifts Made to the Trust Each Year	Minimum the Beneficiary Must Be Allowed to Withdraw So That $12,000 Annual Tax-Free Gifts May Be Made
1st Year	$50,000	$50,000
2nd Year	$10,000	$55,000 (all assets minus $5,000 lapsed from year 1)
3rd Year	$250,000	$300,000 (all assets minus $5,000 lapsed from year one and minus $5,000 lapsed from year 2)
4th Year	$12,000	$299,500 (all assets minus $5,000 lapsed from year 1, $5,000 lapsed from year 2, and $12,500 (5% of $250,000) from year 3.)

From an asset protection perspective, Crummey Trusts are vulnerable to creditors. After all, a creditor of a beneficiary merely needs to wait until the beneficiary can withdraw trust assets, and then they may step in the beneficiary's shoes and invade the trust. One may think a minor could not get in too much trouble, but what if that minor was 16 and got in a car accident? What if the trust remains in force after the child reaches adulthood? Fortunately, there is a solution to this dilemma: have a DEMMLLC (which are explained in Chapter 10) as the trust's beneficiary. The child should of course be the underlying taxpayer for the DEMMLLC. Because DEMMLLCs are ignored as being separate from their owner for tax purposes, we effectively preserve the benefits of the Crummey Trust whilst preventing a creditor from attaching trust assets, even after they're distributed from the trust. We caution, however, that although technically feasible, setting up an LLC where the child (or their custodian, if the child is a minor) is not a manager may lead the IRS to challenge the arrangement as not being a gift of present interests. The authors feel this arrangement will survive such a challenge, but since this matter has not yet been adjudicated, it's best to err on the side of caution.

Finally, we should note that although Children's Trusts most often use Crummey Trust provisions (called *Crummey Powers*), any irrevocable non-grantor trust may include Crummey Powers so as to allow annual tax-free gifts up to the annual exclusion amount.

Credit Shelter Trusts

Perhaps the most common estate tax reduction tool is the *credit shelter trust*. This trust is also commonly known as the family trust, bypass trust, A-B trust,[285] or non-marital trust. It is an irrevocable non-grantor trust, which may be created according to a will or living trust at the time of the first surviving spouse's death, or it may be created beforehand. Typically, the children or other heirs (not including the spouse) are the remainder beneficiaries and the surviving spouse is an income beneficiary. The goal of the trust is to maximize each spouse's $1 million estate tax exclusion, so that estate taxes are only paid on a combined estate in excess of $2 million rather than $1 million. Furthermore, the credit shelter trust may provide income to the surviving spouse during his or her lifetime. The basic strategy is for each spouse to own about half of their combined assets or, if the combined estate is worth more than $2 million, for each spouse to own at least $1 million in combined assets. When one spouse dies, the other spouse keeps their $1 million, or receives a gift from the decedent so that the surviving spouse's property equals about $1 million in value. The excess is then placed into a credit shelter trust, with the children or other heirs as remainder beneficiaries and the surviving spouse as an income beneficiary. The following examples demonstrate why a credit shelter trust may be useful.

> EXAMPLE 1: Dan and Mary are a married couple with a combined estate worth $2 million. Dan owns almost all of the couple's assets. Dan dies in 2012. In accordance with his will, his assets pass to Mary. Because spouses may make unlimited gifts to one another, the almost $2 million gift to Mary is tax free. However, Mary's estate is now worth $2 million. When she dies a year later, her estate is valued at $2 million and her estate pays taxes on $1 million (the value of her estate in excess of the $1 million estate tax exclusion amount), a situation that could have been avoided if $1 million of Dan's estate went into a credit shelter trust instead of to Mary. If a credit shelter trust had been used, Mary's estate could have only been worth $1 million when she died and no estate tax would have been due. Furthermore, she could still have received income from investment returns on the $1 million transferred into the trust. Upon her death both her assets and the trust assets could be distributed to Dan and Mary's heirs tax free.

EXAMPLE 2: Dan and Mary are a married couple who have an estate worth $2 million. All assets are in Dan's name. In 2012, Dan dies. $1 million of his estate goes to Mary, and the rest goes to their children. Because spouses may make unlimited gifts to one another, the $1 million gift to Mary is tax free. The remaining $1 million is also tax free because Dan's estate tax exclusion amount is $1 million. When Mary dies, her $1 million estate (we'll assume it doesn't grow between the time of Dan's death and her death) will also be under the $1 million exclusion amount for her estate, and thus her estate will pass to heirs free of estate taxes. However, Mary wasn't able to receive income from the $1 million inherited by her children from her husband. Furthermore, her children were free to squander their inheritance, which was also exposed to their creditors. A credit shelter trust could have avoided this.

EXAMPLE 3: Dan and Mary are a married couple who have an estate worth $2 million. $1.5 million in assets are in Dan's name, and $500,000 is in Mary's name. In 2012, Mary dies. Mary's estate is distributed to her heirs (or to a credit shelter trust), but when Dan later dies, he still has $1.5 million in his estate, which means he has to pay estate taxes on $500,000. The shortcoming here is that Dan and Mary should have each owned about 50% of their combined marital estate, or each spouse (if the combined estate is worth more than $2 million) should own at least $1 million in their name only. If one spouse owns less than half of the marital assets, or less than $1 million, then if that spouse dies first there is a risk of having to pay estate taxes that otherwise could have been avoided.

As we can see, credit shelter trusts can be a powerful estate planning tool. However, they are best utilized when each spouse separately owns the correct amount of assets (except when the couple lives in a community property state, since in such a state each spouse is automatically deemed to own 50% of marital property). Unfortunately this may not be the best idea from an asset protection perspective, if one spouse is in a significantly higher risk profession than the other. From an asset protection standpoint, it's best to title as many assets as possible in the name of the spouse with the least exposure to liability. However, we can compensate for this by contributing the high-risk spouse's assets, where appropriate, into an LLC or an exempt asset such as life insurance (if such is protected by law) without actually transferring the asset to the other spouse.

Disclaimer Trusts

A disclaimer trust, which is typically incorporated into a will, allows a credit shelter or A-B trust arrangement to be used with more flexibility. This is because oftentimes an A-B trust's only intent is to reduce estate tax liability. When a credit shelter trust is drafted, it may be uncertain to what extent it will be needed to reduce such taxes. The death of both spouses may not occur for many years, and it may be almost impossible to accurately predict how much wealth is in the first spouse's estate when they die, which means it's equally difficult to predict how many assets should go into a credit shelter or marital trust at that time. Furthermore, at the time of the first spouse's death, the surviving spouse may wish to own or have greater access to the deceased spouse's assets than would be allowed for if those assets passed into an A-B trust arrangement.

Incorporating disclaimer trust language into a will allows the spouse to take direct ownership of certain assets when the first spouse dies, or have those assets transferred to a disclaimer trust (which is basically a credit shelter trust), thus "disclaiming" any interest in those assets. Some assets may likewise go into a marital trust (QTIP, etc.)

Making a disclaimer is an irrevocable and absolute election under the IRC where one refuses all or part of an inheritance or other transfer that they would otherwise receive by terms of a will, trust, or state law.[286] When a disclaimer is made, none of the disclaimed property will be included in the disclaiming person's gross estate.[288] In order for a disclaimer to conform to the IRC, the following criteria must be met:

- The disclaimer must be in writing.
- It must be made within 9 months of the asset's irrevocable transfer (usually this is within 9 month's of the first spouse's death.)
- The disclaiming person cannot direct where the disclaimed assets will go, with an exception for a spouse of the decedent. If the disclaiming person is a surviving spouse, then the assets may go into a trust, even if the spouse is a beneficiary of that trust. However, the spouse cannot retain the right to direct the trustee to transfer her interest in the trust, or change beneficiaries of the trust, or otherwise retain any other "power of appointment".[289]
- The disclaiming person must not have accepted ownership of or any beneficial interest an asset before disclaiming it.

Qualified Terminable Interest Property Trusts (QTIPs)

QTIP trusts may be beneficial for any married couple, but they are often most useful for someone who is currently married and who has children from a prior marriage or relationship. The QTIP is "qualified" under the IRC[290] because any transfers made to the trust qualify for the unlimited estate and gift tax exemption for transfers made between a husband and wife (this is commonly referred to as the *marital deduction*, and any trust which qualifies for the marital deduction is a type of *marital deduction trust* or simply *marital trust*). To meet this qualification, however, a QTIP must meet the following criteria:

- The surviving spouse must be entitled to all trust income during his or her lifetime, payable at least annually.
- If a trustee makes any payments of principal during the surviving spouse's lifetime, those payments may only go to the surviving spouse. After the surviving spouse's death, however, the trust may distribute trust principal or income to other beneficiaries.
- A QTIP may be drafted so that the surviving spouse has the power to withdraw trust principal, or so that the trustee may make distributions of principal to the surviving spouse in the trustee's sole discretion. From an asset protection standpoint, if the surviving spouse can withdraw trust principal then so can his or her creditors, therefore the power to make such distributions should rest solely with the trustee, who should be someone other than the surviving spouse.
- At the death of the surviving spouse, all QTIP assets will be included in the spouse's surviving estate for purposes of calculating estate tax liability, even if the spouse does not have access to trust principal during her lifetime. Nonetheless, under the IRC the trust may use trust principal to pay the spouse's estate taxes, even if that principal is distributable to a beneficiary other than the spouse. [291]
- When the first spouse dies, their estate must make a special QTIP election for the QTIP trust to be effective.

In addition to the unlimited marital deduction, QTIPs provide the following benefits:

- The QTIP can manage assets for a spouse who is incapable of doing so.
- A QTIP keeps assets (other than trust income) in trust until the last surviving spouse dies, and then distributes its corpus to the beneficiaries. Thus, a QTIP can make sure the trust's principal goes to children from a prior marriage or relationship. If the assets pass

outright to the decedent's current spouse (if the spouse is from a 2nd or subsequent marriage), then that spouse may not give children from a prior marriage their fair share of inheritance.

- In some instances a QTIP may be used to maximize the GST exemption of the first spouse to die. This is because a QTIP, unlike other trusts that qualify for the unlimited marital deduction, may make an election so that trust distributions, for GST purposes, are treated as transfers made from the 1st spouse's estate rather than the surviving spouse's estate.

From an asset protection standpoint, how does a QTIP measure up? Assuming the surviving spouse has no power to unilaterally withdraw trust principal, and is not a trustee, a creditor may only receive distributions of income during the spouse's lifetime. Unfortunately, these payments must be made at least annually in accordance with the IRC, which effectively prevents a trustee from using a spendthrift or other anti-alienation provision to thwart creditors. The good news is this vulnerability does have a workaround: make the income payments payable to a DEMMLLC where the surviving spouse is the LLC's owner for tax purposes. As long as the DEMMLLC is implemented and operated correctly, a creditor will not have access to trust income payments.

Qualified Domestic Trusts (QDOTs)

A Qualified Domestic Trust, or QDOT, is only useful for a married couple where one spouse is not a citizen of the U.S. Under the IRC, a spouse who is a non-U.S. citizen does not qualify for the unlimited marital deduction (the marital deduction is explained in this chapter's section on QTIP trusts). However, the QDOT does qualify for this deduction. To qualify as such, a QDOT must meet the following criteria:

- The trust must have at least one trustee who is a U.S. person or entity (LLC, corporation, etc.)
- The trust must also meet the same criteria as a QTIP or other trust as defined under §2056 of the IRC.[292]
- The trust cannot make any trust distributions (other than distributions of income) unless the U.S.-based trustee has the right to withhold enough of the distribution to pay U.S. taxes triggered by the distribution.[293] The IRS may also impose additional requirements to ensure that any taxes due are paid.[294]
- Any distribution of trust principal during the surviving spouse's lifetime shall be subject to estate tax upon distribution. Estate tax will also be levied on property remaining in the trust at the time of the surviving spouse's death. These distributions or trust corpus will be taxable as if they were included in the gross estate of the 1st spouse to die.[295]

- A QDOT may be a Charitable Remainder Trust (CRT, which we discuss shortly) if the sole beneficiary is the surviving spouse.

It is important to note that the QDOT has the same asset protection weakness and workaround as the QTIP.

Irrevocable Life Insurance Trusts (ILITs)

The ILIT is a very popular estate planning tool, which also may provide excellent asset protection for life insurance policies purchased in a state that does not exempt such from creditor attachment.

Although life insurance proceeds are income tax free, they are *not* exempt from estate taxes. Thus, if insurance proceeds are payable to the insured person's estate or the estate's executor, the payout will be included in the decedent's gross estate. One way to sidestep this is to make the owner and beneficiary of the policy someone other than the person who is insured, and who will not be an executor over the insured person's estate upon his death. The insured person could then make gifts to the beneficiary to pay policy premiums. Such an arrangement will cause the policy proceeds to *not* be included in the insured person's estate when he dies.

While this arrangement works from a tax savings perspective, is simple to do, and does not require a trust, it has certain drawbacks:

- Life insurance proceeds are often used to pay estate taxes and other expenses when a person dies. However, if the beneficiary is someone other than the decedent's estate or executor, then that person has no obligations to the estate, and may keep the money for himself. Although an ILIT cannot directly pay estate taxes and other expenses without the insurance proceeds being included in the decedent's estate, the ILIT can pay for these expenses in one or more less direct ways, which may include purchasing assets to the estate or making cash loans to the estate.

- In addition to (indirectly) increasing an estate's liquidity, an ILIT can also allow the insured person to direct (through the trust document) how insurance proceeds will be used after he dies. Payouts made directly to an individual beneficiary will be spent or squandered by that individual however he sees fit.

- A beneficiary's creditors may, in some states, be able to attach insurance proceeds. An ILIT can be structured so as to prevent this.

- An ILIT will protect beneficiaries that are receiving aid from various government programs (Medicaid, etc.) so that they may continue to receive such aid.

- If an individual beneficiary dies, the insured person may not be able to control where the policy's beneficial ownership is transferred to. An ILIT will prevent this from happening.

In light of the foregoing, using an ILIT to keep life insurance proceeds outside one's taxable estate is often preferable to naming an actual person as the policy's owner and beneficiary. However, if the trust's grantor retains any "incidents of ownership" over the policy, the policy may still be included in the grantor's taxable estate.[296] Practically speaking, if a person retains any power to change a policy's beneficiaries or otherwise direct who the policy proceeds will go to, to use the policy as collateral for a loan, or to assign, revoke, cancel, or surrender the policy, or to direct the policy's nominal owner to do any of the foregoing, then such powers are an incident of ownership and the policy shall be included in that person's gross estate when he dies. Even if a person needs another's to consent before doing any of the foregoing, if he has any of the aforementioned rights or powers the policy's proceeds will still be included in his estate.[297]

One must also be careful when transferring an existing life insurance policy into an ILIT. If a person dies within 3 years of transferring their policy, the policy will be included in their estate.[298] Finally, if one wishes to make up to $12,000 tax-free gifts each year to the ILIT, the ILIT must have a Crummey provision. And, like all Crummey trusts, one should consider reinforcing the trust against a beneficiary's creditors by placing the beneficial trust interest in a DEMMLLC.

Qualified Personal Residence Trusts (QPRTs)

QPRTs are an excellent way to pass one's home to heirs while realizing estate tax savings. However, in light of recent case law a QPRT's asset protection benefits are questionable, and using a QPRT involves taking a calculated risk, which we'll soon discuss. A generally superior alternative to the QPRT is the non-QPRT, which we examine in the next chapter.

QPRTs are governed by §2702 of the IRC[299] and essentially allow someone to give their home to heirs while retaining the right to live in the home for a set number of years. Because the right to live in the home for a number of years has a cash value roughly equivalent to the fair market value of renting the home for the same time period, this amount, in accordance with tables published by the IRS, is deducted from amount of the taxable gift made when the home is put into the trust.

For example, let's say John owns a $1 million home free and clear. He puts the home in a QPRT while retaining the right to live in the home rent-free for 10 years. Under the current table rate, John's right to live in the home for 10 years is worth $675,636, which means contributing the home to the trust constitutes a

$324,364 gift (the value of the home minus the value of his retained right to live in the home rent free for 10 years.) If the home appreciates at 5% per year, then at the end of the 10 year period, when the home passes to John's heirs, the home has appreciated to $1.63 million, however the taxable gift remains at only $324,364; $1.3 million has thus been removed from John's gross estate, tax free.

Despite the advantages of a QPRT, it is not without its drawbacks. First and foremost are the tax consequences if the grantor dies before his right to live in the home rent-free terminates. If this happens, then not only is the entire home's value included in his gross estate, but furthermore he loses the lifetime gift tax credit amount that was allocated to the gift. This means, in the foregoing example, John cannot regain the $324,364 gift he made and the entire home value is left in his taxable state, which puts him in a worse position than had he not used a QPRT. Because of this, most planners do not allow a QPRT's grantor to retain right to live in the home for more than five or ten years. If a grantor wishes to remain in his home beyond the term set forth in the QPRT, they may do so, but only if they pay fair market value rent for continuing to live there.

From an asset protection standpoint, a QPRT provides questionable asset protection. If a creditor obtained a judgment against the grantor, at the very least he could evict the grantor from the home and then rent it out to help pay off the judgment debt. However, QPRTs are also vulnerable to fraudulent transfer rulings until the four year (or sometimes longer) statute of limitations runs out. The reason for this is twofold. First, the home is transferred to the trust as a gift without consideration. Second, the transferor continues to benefit from the property by living in it rent-free, which is a badge of fraud under the UFTA.[300] In regards to no longer owning a home but continuing to live in it, at least one court has noted that "retention of the [rent-free] use of the transferred property very strongly indicates a fraudulent motive underlying the transfer."[301] The point here is that even if a transfer into a QPRT is not intended to defraud creditors, it is more vulnerable to being seen as an attempt to do so.

Charitable Remainder Trusts (CRTs)

The CRT, as defined by §664 of the IRC, is a popular estate planning tool that provides for multiple benefits. Essentially, a grantor transfers property to a CRT and receives annual payments from the trust for his lifetime or for a designated number of years, after which the trust terminates. Upon the trust's termination, all remaining assets (the remainder) pass to a charity or charities in accordance with the trust agreement. Even though remaining trust assets do not pass to charity until the trust's termination, the grantor is allowed an income tax deduction the year the trust is created that is equal to the estimated value of the charitable remainder gift.[302] This deduction is often very significant. For example, let's say

Tim creates a CRAT and funds it with $1 million. The CRAT will terminate upon his death, and in the meantime he receives annual income payments of $100,000 annually. In accordance with IRS-approved actuarial tables, by the time Tim dies the trust should have a remainder of $500,000. This means, in the year the trust is created, Tim may take a $500,000 income tax deduction. Assuming Tim receives $500,000 or more that year as ordinary income, then his tax savings will be more than $170,000.

There are essentially three types of CRTs: the Charitable Remainder Annuity Trust (CRAT), Charitable Remainder Unitrust (CRUT), and the Net Income with Makeup Charitable Remainder Unitrust (NIMCRUT). CRATs distribute a fixed dollar amount each year, whereas a CRUT has a percentage of overall trust assets distributed each year; the value of the CRUT's corpus is evaluated annually in order to determine the actual dollar amount distributed. We will discuss the NIMCRUT later in this section.

For a CRT to qualify as such, it must meet the following criteria:

- A CRAT must pay at least 5% but no more than 50% of its initial corpus annually;[303] a CRUT must pay at least 5% but no more than 50% of its corpus in accordance with its annual valuation amount.[304]
- At least 10% of the CRT's initial corpus must pass as a remainder to charity.[305]
- A CRT may last a maximum of 20 years, or for the lifetime or lives of the grantor(s). [306]
- When the grantor(s) die, all remaining trust assets must pass to a charity that meets the criteria set forth in §170(c) of the IRC.

CRT's are ideal for almost anyone who plans to give away some of their estate to charity when they die. This is because a normal charitable gift upon their death only qualifies for an estate tax deduction, wherein the gift is not included in the grantor's taxable estate. However, property gifted to a CRT qualifies for an estate tax *and* income tax deduction, plus the CRT assets may be invested and grown inside the CRT tax free; only annual distributions to the grantor are taxable when they are made.[307] Because a CRT's assets are exempt from taxation while in the trust, many tax planners recommend the transfer of highly appreciated assets to a CRT so those assets may be sold tax free while the assets remain in trust.

Although many people like the fact that CRT's meet their charitable goals while providing a steady income stream and a sizeable income tax deduction, some people are hesitant to use one because they'd rather have their wealth pass to heirs. However, if a CRT is used in conjunction with a Wealth Replacement Trust, then the grantor, charity, and heirs all come out on top. This is because the income tax deduction taken when a CRT is funded provides extra cash that may be used to purchase a life insurance policy held in the Wealth Replacement Trust, which is essentially an ILIT. When the CRT's grantor dies, the life insurance proceeds pass to heirs in lieu of the charitable gift. Thus, the charity receives the gift from the CRT, the heirs receive the life insurance proceeds, both assets pass outside the grantor's taxable estate, and everyone is happy.

Though CRTs have many benefits, one complaint we often hear is that a grantor must receive distributions from the trust each year. Many individuals would prefer to receive little or no distributions initially, and then receive more distributions later after they retire. To some extent, we can meet this goal with a Net Income with Makeup Charitable Remainder Trust, or NIMCRUT. With a NIMCRUT, the lesser of trust income or the annual unitrust distribution are distributed each year, and if annual income is less than the unitrust distribution, this deficiency can be "made up for" in later years when income is greater. The bottom line is a correctly structured NIMCRUT allows one to take out less in the trust's early years and more in later years, when retirement income is needed. Of course, for maximum effect the NIMCRUT should be funded with assets that produce little or no income. Later on, those assets could be sold and used to purchase high income-producing assets.

Of final note is the fact that the payout features of the NIMCRUT and standard CRUT can be combined into a *flip unitrust*. With a flip unitrust, the trust can start as either a NIMCRUT or CRUT until a triggering event occurs (as defined in the trust document), upon which the payout method switches to the other method.

From an asset protection perspective, how does the CRT fare? The answer is the principle fares well but the income distributions may be attached by a beneficiary's creditor as they're made. The workaround, of course, is to make the beneficiary a DEMMLLC. Although a person or entity other than the grantor or DEMMLLC may be used, this may not be a good idea as the income will probably then constitute a taxable gift from the grantor to the beneficiary. Since the DEMMLLC is completely disregarded from the grantor, however, it may safely be designated as the CRT beneficiary without triggering adverse tax consequences.

Charitable Lead Trusts (CLTs)

The CLT is very similar to the CRT, except the payout method is reversed. This means that instead of annual income payments going to a non-charitable beneficiary and the remainder to charity, with a CLT the annual payments go to charity and the remainder goes to the grantor's heirs or other non-charitable beneficiaries.

Although CLTs are less popular than CRTs, they nonetheless have their uses. Their biggest advantage is the reduction in estate taxes when transferring the trust's remainder to heirs. This is because the trust's grantor is allowed an estate and gift tax deduction for the annual charitable annuity or unitrust payments. The following example illustrates how this works:

> Michelle transfers $1,000,000 in bonds to a 10-year, six-percent CLT. For 10 years, $60,000 per year will be distributed to the charity. The owner receives a charitable-gift deduction equal to $486,654 (the present value of the annuity interest). The taxable gift of the remainder is $513,346. Assuming that the trust earns at least six percent per year, in 10 years the principal amount of at least $1,000,000 will pass to the owner's children for a gift of slightly more than half of its value.

Because CLTs distribute income annually to charity, it is best to contribute appreciating or income-producing assets to the trust. This helps ensure the remainder that transfers to heirs will remain sizeable while also allowing for a significant estate tax deduction.

Because CLTs are not self-settled trusts (unlike CRTs, where the grantors are usually also income beneficiaries), they fare better from an asset protection perspective and usually no further asset protection measures need to be taken. However, it may be a good idea to transfer the trust principle, upon the CLT's termination, to an irrevocable trust so that heirs cannot squander the inheritance, in addition to ensuring trust assets remain outside the reach of the heir's creditors.

Grantor Retained Annuity Trusts (GRATs)

A Grantor Retained Annuity Trust (GRAT) involves a person gifting assets to an irrevocable trust while retaining the right to receive annual trust annuity payments for a number of years. Because of this retained right, the grantor may subtract the value of the retained right from the value of the gift in accordance with valuation rules as found in §7520 of the IRC.[308] At the end of the specified term, trust assets then pass to a beneficiary and are no longer included in the grantor's taxable estate. The benefits of a GRAT are illustrated in the following example:

> Tracy gifts $500,000 to a GRAT wherein she retains the right to annually receive an annuity of 4% of trust assets as measured by their initial value ($40,000) for ten years. After ten years, the remaining trust assets (the remainder) shall be paid to her two children Pam and Tony. In accordance with IRC §7502 tables, her retained right to annual annuity payments is valued at $217,665, meaning she only makes a taxable gift of $282,335 at the time she transfers her $500,000 into the trust. Essentially, she has transferred $217,665 of the $500,000 to her children gift-tax free.

For a GRAT to qualify as such under the IRC, it must meet the following requirements:

- The annuity must be a fixed amount paid at least annually, regardless of whether the trust's income is higher or lower than that amount.[309] Notwithstanding this, the trust document may specify varying payouts for each year of the trust's existence, as long as those amounts are set forth in the original document and the amounts are not changed later on. In other words, a trust may specify that a GRAT will pay out $50,000 the first year, $75,000 the second year, $60,000 the third year, and so on. However, a GRAT is not valid if the trustee has discretion to determine the annual payout, or if the annual payout amount, as specified in the trust, may be changed or amended later on.
- The term during which annuity payouts are made must be a specific and fixed length of time as set forth in the trust document.[310]
- During the annuity payout term, payments must be made only to the annuitant as specified in the trust. [311] However, an annuity may be paid to the grantor's spouse so long as the grantor retains the right to revoke the annuity so that payments are afterwards made to the grantor upon revocation.[312]
- Early annuity payments (a.k.a. "commutation") are not allowed.[313]
- The annual annuity payment *must* be made at least each year before the deadline for filing the trust's tax return (without extensions).[314]
- The annuity amount must be prorated for short tax years (meaning if the trust begins or terminates so that, for example, in its first or last year the trust exists for only 7 months out of the calendar year, then only 7/12th of the normal annuity amount will be paid that year.)[315]
- A GRAT's trustee may distribute assets back to the grantor (or the annuitant, which is the person who receives the annuity) other than annuity payments, however these extra payouts will not further reduce gift or estate taxes.[316] Nonetheless, since a GRAT is often a grantor trust (meaning its tax liability is often paid by the grantor) the trustee will often distribute enough assets to the grantor to pay for taxes, in addition to the annuity payout. Distributing extra amounts back to the grantor, of course, reduces the extent to which a GRAT's assets pass out of the grantor's taxable estate, and thus doing this may be harmful from an estate tax savings perspective.
- The trust document must specify that there may be no additional contributions to a GRAT after its initial funding.[317]

Finally, a few things must be kept in mind when using a GRAT. First, a taxable gift is made when the trust is initially funded, not when the remainder is distributed to heirs. However, the taxable amount of this gift will not increase, even if the remainder ends up being substantially larger than what was originally anticipated.

Second, if the grantor dies before he receives all his annuity payments, then much or all of the GRAT's corpus will be included in his taxable estate. Therefore, the term in which annuity payouts are to be made should be shorter than the grantor's life expectancy, while also allowing for a wide margin for error in case the grantor dies earlier than expected.

Third, although a GRAT's remainder will pass to heirs free of additional gift or estate taxes, they may not be free of generation skipping taxes (GST). Therefore, caution is advised whenever a GRAT's remainder beneficiary is a grandchild of the grantor, or a person who might otherwise trigger GST liability.

Finally, like all trusts where the grantor retains an interest in trust assets, annuity payouts should be made to a DEMMLLC instead of to the grantor directly if the grantor desires maximum asset protection.

Grantor Retained Unitrusts (GRUTs)

A GRUT is just like a GRAT, except the annual payout is a percentage of the trust assets' value as calculated each time the payout is due, instead of a fixed amount calculated only when the trust is initially funded. In other words, if a GRAT is funded with $1 million, and annual payouts are specified at 5% per year, then the annual payouts will be $50,000 each and every year. However, if the same situation were applied to a GRUT, and the GRUT's corpus was $1 million the first year, $2 million the 2nd year, and $500,000 the 3rd year, then payouts would be 5% of the corpus' value each year: $50,000 the 1st year, $100,000 the 2nd year, and $25,000 the 3rd year. These annual payouts are called unitrust payments instead of annuity payments.

As with a GRAT, a GRUT does *not* pay trust income to the grantor. Rather, it pays an annual annuity which may be higher or lower than trust income. If the annual annuity is higher than trust income, then trustee may use some of the trust's principle to pay the annuity.

As with a GRAT, the value of the right to receive annual payments from a GRUT is subtracted, for gift tax purposes, from the value of the assets gifted to the GRUT. However, because of the nature of GRUT payouts, a GRUT may be more or less desirable than a GRAT for the following reasons:

- Overall, if trust assets grow more than is anticipated in the IRC §7520 valuation tables, then a GRAT will save more gift taxes than a GRUT. However, if trust assets grow slower than anticipated, or if they depreciate in value, than a GRUT provides more gift tax savings than a GRAT.
- A GRAT usually provides greater overall tax savings since excess growth stays in the trust and goes to heirs, whereas with a GRUT excess growth means more is distributed annually to the grantor or other annuitant.

- A GRUT is preferable if the grantor wishes to retain more of the annual earnings from high yield and/or highly appreciating assets.
- Since assets in both a GRAT or GRUT will be included in the grantor's estate if he dies before the trust's payout term expires, the purchase of life insurance will make up for the extra tax liability if the grantor dies prematurely.

Intentionally Defective Grantor Trusts (IDGTs)

Sophisticated estate planners know that even though a grantor trust is disregarded from its owner for income tax purposes (meaning the grantor pays the trust's income tax), the same may not always be true for estate and gift taxes. Although the corpus of a grantor trust is usually included in the grantor's gross estate when he dies, there is an exception to this rule with the Intentionally Defective Grantor Trust (IDGT).[318] This is also true for the Defective Beneficiary-Taxed Trust (DBETT), which we discuss in the next section.

IDGTs are designed so as not to be included in the grantor's gross estate. Furthermore, gifts made to an IDGT are complete for gift tax purposes and therefore subject to gift tax at the time they're made. Notwithstanding this, IDGT's are "intentionally defective" so that the grantor, not the trust, is liable for the trust's income taxes. This intentional defect is beneficial from an estate planning perspective because, if the grantor pays for the trust's taxes, then the grantor has an opportunity to move more wealth out of his taxable estate while allowing the trust to keep more wealth that will ultimately pass to heirs.

Besides being irrevocable, the reason IDGT's are separate from the grantor for gift and estate tax purposes but not for income taxes has to do with its method of funding. In a nutshell, when a trust's grantor borrows trust corpus from a non-grantor trust in the form of an unsecured loan, he becomes liable for income taxes attributed to that property until the promissory note is completely satisfied. If a grantor borrows or purchases all of the trust's assets, then he is considered the 100% owner of the trust for income tax purposes, even though the trust is otherwise a non-grantor trust.

An IDGT is typically created in the following manner:

1) A grantor makes a taxable gift of cash or other property to a non-grantor, irrevocable trust. This property should be at least 10% of the value of the assets the grantor plans to later sell to the trust. This ensures that the assets later sold to the trust will not be used as the sole source for paying off the promissory note. If the assets were the sole source of note payments, those assets could be at risk of being treated by the IRS as a retained interest of the grantor, which would cause the trust to be included in the grantor's gross estate.[319]

2) The grantor then sells income-producing property to the trust, and the trust issues the grantor a promissory note plus its initial funding of cash or other property. The initial funding is a down-payment on the purchase, and trust income is used to make note payments.
3) Usually the promissory note calls for interest-only payments with a balloon payment due when the trust terminates after the grantor's death. The note will be included in the grantor's gross estate when he dies. However, because the note is unsecured, it is worth less, for estate tax purposes, than its face value. This "discount" is similar in concept to the valuation discounts given to limited partnership interests (although the discount is not for the same reason).
4) The interest rate on the note should be, at a minimum, the applicable federal rate. The applicable federal rate is a loan interest rate published monthly in the Internal Revenue Bulletin. To the extent the note's specified interest payments are below this rate, a taxable gift occurs; this is known as a "gift loan". Fortunately, the minimum interest rate as specified by the IRS is low, usually in the 3-4% range.
5) To maximize estate tax savings, property is often put in a family limited partnership (FLP) before it is sold to the trust.[320] Then, the limited partnership interest is sold to the trust instead of the actual property (which remains the property of the partnership.) This strategy allows for a double discount: the FLP discount plus the discount on the unsecured promissory note.

In some ways an IDGT functions like a GRAT, because the trust's payments on the promissory note act like annuity payments from a GRAT. However, an IDGT has a few advantages over the GRAT. These include the following:

- The minimum interest payments required to be made by an IDGT are typically lower than the required minimum GRAT payouts. This means more wealth passes to heirs instead of going back into the grantor's estate.
- All of an IDGT's income tax is paid by the grantor, further reducing the size of his estate while preserving trust corpus. With a GRAT, the grantor pays tax on his annuity payments only. If the trust's income exceeds such payments, the trust must pay tax on the excess.
- Some or all of a GRAT's principle will be included in the grantor's gross estate, including appreciated property, if the grantor dies before the end of the GRAT's payout period. If trust principle includes limited partnership or other closely held business interests, the inclusion of

these interests in the grantor's estate could negate valuation discounts that would otherwise be available. IDGT principle, however, will not be included in the grantor's estate regardless of when he dies.

- Trust beneficiaries can enjoy IDGT property immediately, whereas with a GRAT they must wait until the payout period ends.

From an asset protection standpoint, there is a glaring weakness with the IDGT: since the grantor is, at the very least, an income trust beneficiary, the trust is at least to some extent self-settled and thus exposed to creditor threats. This problem is solved by using a DBETT trust, which we discuss in the next chapter.

Other Estate Planning Trusts

This chapter has described most of the major estate planning trusts currently in use. However, as estate tax law, fraudulent transfer law, and other laws evolve over time we can expect some trusts to become obsolete while new planning opportunities emerge. While the latest, most cutting-edge trusts are discussed in the next chapter, there are a few additional trusts that are also worth mentioning here very briefly. These include non-grantor trusts that are qualified to hold S corporation stock (known as Qualified S Corporation Trusts (QSSTs) and also Electing Small Business Trusts (ESBTs)) as well as a trust designed to reduce an elderly person's property ownership so that they qualify for Medicaid assistance, which is called a Medicaid Trust. Although we won't go into the specifics of these trusts, they do provide estate planning benefits as well as some asset protection, and anyone interested in these trusts should contact our office for more information.

CHAPTER FOURTEEN

Cutting-Edge Trusts

In previous chapters we have discussed trusts that have been traditionally used for either asset protection or estate planning purposes. As with most fields of study, however, new strategies are constantly being developed (this is akin to new technologies being developed in the world of science.) This chapter is dedicated to examining the most state-of-the-art, recent, cutting edge trust developments in estate and asset protection planning. Few planners are aware of these trusts. Even fewer (only a few nationwide, actually) know how to implement and use them for maximum benefit. Generally speaking, the following trusts are significantly superior to their traditional counterparts.

Non-Qualified Personal Residence Trusts (Non-QPRTs)

In the previous chapter we discussed the Qualified Personal Residence Trust, or QPRT. While a QPRT has many potential benefits, it also has some glaring drawbacks; namely, if the grantor dies before their right to live in the home tax-free expires, they will be worse-off, from an estate-tax standpoint, than if they had not used a QPRT at all. Furthermore, the QPRT's asset protection benefits are questionable at best. How then might one overcome a QPRT's asset protection and potential tax shortcomings? One way is to use a non-QPRT, also referred to as an NQPRT. A non-QPRT is basically a trust that holds a home while not being qualified for estate tax savings under IRC §2702. Nonetheless, estate tax savings may still be realized, although not in the same way as with a QPRT.

A non-QPRT is a non-self-settled, irrevocable grantor trust that buys the home. It is taxed like an IDGT (which we discussed in chapter 13) so that trust assets are not included in the seller's estate. Simply put, the trust gives the seller a self-canceling installment note (SCIN) in exchange for his home. As we discussed in the chapter on trust fundamentals, an SCIN is a promissory note to pay a debt in regular installments, however if the note-holder dies, then the note is cancelled and the trust owes no further payments; the home is now owned free and clear by the trust. As long as the promissory note's value is equivalent to the fair market value of the home, the transfer of the home to the trust in exchange for the SCIN is an exchange of equivalent value and thus the transfer is much less likely to be considered fraudulent.

After the transfer, the seller pays fair market value rent to the NQPRT for his continued use of the home, which the NQPRT in turn uses to make payments on the SCIN. After the fraudulent transfer statute of limitations expires, one may safely engage in more aggressive estate tax savings, if desired, by forgiving up to $24,000 in note payments per year as a split gift between husband and wife. Thus, rent payments are made to the trust, which reduces the seller's taxable estate, and the trust can keep more of those payments from going back to the seller since it now pays less (or nothing) on the SCIN. When the seller dies, the home and any rent payments that have accumulated in the trust are not included in his gross estate. Trust property instead passes to his heirs, who are residual beneficiaries of the trust.

The NQPRT is a stronger asset protection tool than the QPRT because the home is transferred to the trust in exchange for something of equivalent value (the SCIN), and furthermore the transferor does not live in the home rent free. There is also less risk with a NQPRT from an estate tax perspective, since there is no term of years the transferor must survive in order to make sure the trust reduces estate tax liability.

A NQPRT is often a more effective tool than a QPRT, but it may not be a good idea for anyone who only wishes to protect their home. Remember, a NQPRT is an irrevocable trust, meaning once you make the transfer, you can't get the home back. For maximum asset protection, the transferor shouldn't retain the right to direct the trustee to sell the home, purchase a new home, or distribute trust funds to the transferor (the trust may however be drafted so that the residual beneficiaries have limited powers to direct the trustee in such a manner). A NQPRT, like the QPRT, is meant to eventually pass a home to one's heirs. Furthermore, transferring a mortgaged home to a non-QPRT may cause problems with the mortgage holder, which means only unencumbered homes, or homes whose mortgage could be paid off, are ideal candidates for a non-QPRT unless the mortgage holder agrees to the transfer. Therefore, if the parameters of an NQPRT do not match an individual's goals and circumstances, they should protect their home via equity stripping, which is discussed in chapter 15. Alternatively, a person could move to one of the five states that protect 100% of a homestead's value from creditors, or perhaps use a Domestic Asset Protection Trust (DAPT) if his state of residence has passed DAPT legislation (however the authors recommend DAPTs only if none of the other strategies are feasible).

Defective Beneficiary-Taxed Trusts (DBETTs)

The relatively recent emergence of asset protection as a mainstream practice field has resulted in an improvement of several estate planning tools. The Defective Beneficiary-Taxed Trust, or DBETT (also known as the Beneficiary Defective Trust or Beneficiary-Taxed Irrevocable Trust (BETIR Trust)), is one example of such improvements. It is similar to an IDGT except it is not self-settled, and thus it is a stronger asset protection vehicle. The DBETT may very well be one of the best overall asset protection and estate planning trusts available, as we'll explore them more thoroughly in the very next section.

The means for creating a DBETT is set forth in §678 of the Internal Revenue Code. According to §678(a)(1), if a beneficiary has the power to withdraw or otherwise take possession of all of a trust's principal or income, then he's considered to be the 100% owner of the trust for income tax purposes, in the same manner as a grantor would be the owner, for income tax purposes only, of an IDGT. This power, however, may lapse after a period of time (30 days, for example), after which, as long as the beneficiary retains one of the powers that would make the trust a grantor trust under §671-677 of the IRC, the trust will continue to be beneficiary taxed.[321] In other words, we can create a DBETT the same way we create an IDGT, but with the following differences:

1) After a beneficiary's power to withdraw trust assets lapses, he will transfer an asset to the DBETT in exchange for an unsecured promissory note of equivalent value, just like a grantor would do with an IDGT.
2) The grantor can be anyone besides the beneficiary or his spouse (the spouse may be acceptable as grantor in some cases, but not in most), and can be funded with an asset worth as little as 1% of the value of the target asset that will later be transferred to the trust. For maximum asset protection, the best case scenario would be for the grantor to not be an insider of the beneficiary under fraudulent transfer law.

3) After the beneficiary's withdrawal right lapses, the trustee, who should ideally be someone who is not an insider of the grantor or beneficiary under fraudulent transfer law, should have full discretionary and spendthrift withholding powers so as to be able to protect trust corpus from creditors.

DBETTs have the same estate tax planning advantages as IDGTs: the grantor (or, in the case of a DBETT, the beneficiary) pay all trust income taxes, which helps reduce his taxable estate, and trust assets are not included in a person's gross estate when he dies. However, in contrast to IDGTs, DBETTs are not self-settled and thus can provide excellent asset protection. Furthermore, so long as a DBETT's funding involves an exchange of equivalent value, it provides substantially stronger asset protection than even a conventional non-self-settled trust that receives its corpus without consideration. For these reasons, many planners consider the DBETT to be the most asset-protected domestic trust available.

DBETT Planning Opportunities: The Ultimate LLC (ULLC) and Synthetic Roth IRA (SynRoth)

As a state-of-the-art asset protection and estate planning tool, the DBETT may be used to enhance existing asset protection and/or estate planning strategies, or it may be used as a stand-alone structure to provide benefits no other structure can. We'll briefly examine two of the strategies, the *Ultimate LLC*[322] (ULLC) and the *Synthetic Roth IRA* (SynRoth), although the DBETT certainly has other applications as well.

As we discussed in Chapters 9 and 10, LLCs and LPs benefit from Charging Order Protection, and are thus often referred to as Charging Order Protected Entities, or COPEs. COPEs may also be used in tandem with the valuation discount strategy to significantly reduce estate tax liability. However, while the charging order and valuation discount strategies both provide significant benefits, neither of these benefits are absolute. In other words, although the charging order prevents a creditor from gaining control or becoming a member of a COPE, or attaching the COPE's assets, a creditor may still be able to seize those assets (including company profits) if and when they are distributed from the COPE to its owners. Likewise, although the valuation discount strategy reduces the value of a COPE's assets for estate tax purposes, those assets may still generate significant estate tax liability.

What if we could make it so a creditor could not get a charging order against a COPE, and what if we could make a COPE's assets pass outside a person's estate, without incurring gift tax liability, so that these assets may pass to heirs completely free of estate taxes? This is possible if we combine a COPE with a DBETT.

The strategy works like this:

1) An LLC owner sells his company interest to a DBETT. In return, the DBETT gives the owner a promissory note to pay for the purchase in installments. This note could be either a traditional note or an SCIN, as desired.
2) The COPE's profits, or the sale and liquidation of COPE assets, are used to pay the promissory note. The promissory note states that the DBETT may withhold payments if those payments would be attached by the note holder's creditors. Perhaps as an extra layer of security, the note could also be transferred to another COPE.
3) Because installment payments are made on the note, the former owner of the COPE now receives a steady income from the DBETT. After the note is paid off, the COPE's former owner may still receive trust distributions as a beneficiary of the trust.
4) In the event of creditor attack, the owner no longer owns the LLC, and his beneficial interest in the trust is subject to a spendthrift provision, which keeps trust assets 100% out of a creditor's reach. This means a creditor cannot get a charging order against the COPE. Whereas before their creditor remedy, the charging order, was slim and usually inadequate, now the remedy is completely nonexistent.
5) Finally, when the COPE's former owner dies, the DBETT's assets are not included in the former owner's gross estate. If an SCIN is used, then any remaining amount owing on the promissory note is cancelled and likewise not included in the noteholder's gross estate.
6) There are three other possible benefits to using a DBETT. First, the sale of a COPE's interest to the trust is an exchange of equivalent value that greatly reduces the sale's likelihood of being considered a fraudulent transfer. Second, since an LLC is now owned by a DBETT, it is now irrelevant whether the LLC needs to have more than one member in order to benefit from charging order protection, since the LLC would never be subject to a charging order as long as the trust is never sued directly (and careful planning would ensure the DBETT is never exposed to risk of litigation.) Third, since the DBETT adds an extra layer of protection, and does not need to have a business purpose, it will be almost impossible to reverse-pierce an LLC if DBETT and LLC

assets are commingled, or the LLC is not used properly (however any structure will probably be pierced if it is used to perpetrate fraud or similar injustice).

A comparison of the benefits of the ULLC as opposed to its traditional counterpart is summed up in table 14.1, below.

Table 14.1 Traditional LLC vs. The Ultimate LLC (Advantages are Underlined)

	Traditional LLC	**Ultimate LLC (LLC Owned by a DBETT)**
Estate Tax Benefits	If the LLC is properly structured, then its assets may be devalued by 20% to 50% for purposes of calculating estate tax liability.	LLC assets pass to heirs completely free of estate taxes.
Creditor's Ability to Reach Assets Held in an SMLLC	A creditor can reach SMLLC assets if a judge disallows charging order protection.	SMLLC assets are not attachable by creditors.
Creditor's Remedy Against a Debtor-Owner of and LLC	A creditor may receive the right, via a charging order, to attach assets as they are distributed from the LLC to a debtor-owner.	A DBETT's spendthrift provision keeps a creditor from attaching LLC assets even if they're distributed from the LLC. The law does not allow a charging order or other creditor remedy to attach to a debtor's beneficial interest in a DBETT.
May Be Reverse-Pierced?	Yes, if it has no business purpose, LLC and personal funds are commingled, or the LLC is used to perpetrate fraud or a similar injustice.	Almost impossible to reverse-pierce, unless the ULLC is used to perpetrate fraud or similar injustice.

Another DBETT strategy is often referred to as a Synthetic Roth IRA, or SynRoth. The SynRoth is a planning tool that mimics the traditional Roth IRA, but lacks many of its restrictions and drawbacks. Like the traditional Roth, a SynRoth is funded with after-tax dollars, however distributions from the SynRoth are tax-free. The SynRoth is also more heavily asset protected, even in states that don't exempt Roth IRAs from creditors, does not have low annual contribution restrictions, and is not subject to estate taxes; neither is it subject to the income in respect of decedent (IRD) tax that a traditional non-Roth IRA would be subject to.

In essence, a SynRoth is a DBETT that purchases a life insurance policy with assets sold to it by its beneficiary. This policy will insure the beneficiary's life, and could be from a domestic insurer, or for greater potential growth, it may also be from a foreign insurer (we talk about foreign insurance in the next chapter.) A SynRoth acts somewhat like an ILIT inasmuch as the insurance proceeds are not included in the insured person's estate when he dies, however it also acts like a Roth IRA inasmuch as the insured person may receive retirement income by borrowing from the policy's cash value as the policy is invested and grows. By using the insurance policy as an "insurance wrapper" investment vehicle, the insured person may invest in domestic investments with a domestic policy, or global investments with a foreign policy. Furthermore, wealthy or even merely "well-to-do" individuals may purchase insurance in amounts that far exceed the annual $5,000/6,000 contribution limit[323] allowed a Roth IRA, insurance proceeds or amounts borrowed from the policy are income tax free, and unlike with a traditional Roth, there is no 10% tax penalty for withdrawing cash from the SynRoth before age 59 & ½. Furthermore, unlike with traditional IRAs there are no required distributions that must be made once the insured person attains the age of 70½. Table 14.2, below, compares the SynRoth to the traditional and traditional Roth IRA. In light of these benefits, anyone who wishes to annually invest $10,000 or more after-tax dollars in a tax-free retirement account should consider the SynRoth.

TABLE 14.2 Traditional Roth IRA and Traditional IRA vs. the SynRoth (Advantages are Underlined)

	Traditional IRA	**Roth IRA**	**SynRoth**
Funded with Before or After-Tax Dollars	Before-tax dollars (tax deductible)	After-tax dollars	After-tax dollars
Tax Free Distributions	No	Yes	Yes
Possible IRD Tax Liability	Yes	No (IRD tax free!)	No (IRD tax free!)
Included in Gross Estate (Higher Estate Taxes for Larger Estates)	Yes	Yes	No (estate tax free!)

Funded with Life Insurance	Prohibited	Prohibited	Yes; may also be funded with other assets but these may not generate tax free growth. However, life insurance is normally used as an "insurance wrapper" to access other domestic or foreign investments
Annual Contribution Limit (2008)	$5,000, or $6,000 if 50 or older	$5,000, or $6,000 if 50 or older	Limit depends on the amount of life insurance one may purchase, which is determined by a person's age and net worth. For a high-net worth individual, this amount will be much, much higher than the annual contribution limit for IRAs
Protected from Creditors	Only if protected by state law (some states afford protection, some don't.)	Only if protected by state law (some states afford protection, some don't.)	Yes, protected in all states
Required Distributions	Required minimum distributions begin at age 70½	No	No
Early Withdrawal Penalty	Penalty is 10% of any amount withdrawn before age 59½	Penalty is 10% of any amount withdrawn before age 59½	No

Dynasty Trusts

Most trusts, by law, cannot last forever because of the rule against perpetuities, which we discuss in Chapter 11. However, some states and foreign countries have abolished this rule, which in theory could allow a trust to survive forever, and certainly allows certain trusts to exist much longer than their traditional counterparts. Such trusts, which are called *dynasty trusts*, can be very powerful estate planning tools, since their corpus can remain forever exempt from gift, estate, and generation skipping taxes (GST). The following example illustrates this point:

> If $2 million were transferred GST tax-exempt to a dynasty trust, and corpus then grew at eight percent compounded annually, the trust's corpus would be $206,344,700,133 after 150 years (Albert Einstein supposedly once said compound interest is the most powerful force in the universe. Whether or not he actually said that, this example proves the statement true!) If that same $2 million had grown at the same rate but had been subject to estate taxes every generation (we'll assume this is every 30 years), after 150 years there would only be $4,931,928,585.

By nature, all dynasty trusts are irrevocable spendthrift trusts that are often but not always non-self-settled. They are meant to pass wealth to future generations completely free of estate, gift, and GST tax. Dynasty trusts may be domiciled in certain states (most notably, Alaska and Delaware, although other dynasty trust states include Nevada, Oklahoma, Illinois, Rhode Island, and Utah.)

When forming a dynasty trust, one must pay special attention to five major areas:

1) Ensuring the most ideal assets are transferred to the trust, and that these assets are exempt from GST by making a special election;
2) choosing which jurisdiction the trust will be established in;
3) knowing the rules for creating and maintaining a dynasty trust in that jurisdiction;
4) what type of dynasty trust should be used (a pot trust, generational subtrust, or a dynasty ILIT, which we'll discuss shortly); and
5) how might the trust be structured so as to allow for an "exit strategy" (trust termination) if necessary, as well as to allow sufficient flexibility to handle unforeseen challenges?

One of the most important considerations is to make sure all assets transferred to the trust have had a GST exclusion allocated to them. Failure to do this means at least some trust assets will be subject to transfer taxes for each successive generation of beneficiaries. Consequently, many dynasty trusts contain language specifically prohibiting a trustee from acquiring any property that has not had a 100% GST exclusion allocated to it. Furthermore, because each person only has a $2,000,000 lifetime GST exclusion to allocate they should only make allocations to "non-wasting" assets such as real estate, perpetual-duration company stock (a company that terminates in 30 years, for example, may not be an ideal contribution unless it owns assets of a permanent nature), collectibles, etc. as opposed to perishable or short-term duration items. Dynasty trusts are best used to hold "permanent" items that will exist for a long time and grow in value or continuously produce income. A great asset to fund a dynasty trust with is life insurance; some dynasty trusts are even structured like ILITs to specifically hold life insurance as its primary asset. A

$2 million premium payment made when the insured person is 50, for example, will have a death benefit of about $6.5 million. If the policy is purchased by or immediately transferred to the dynasty trust, then $6.5 million will effectively pass outside the grantor's estate free of GST. Premium payments may also be made over time so as to allow for $12,000 annual tax-free gifts or $24,000 annual split-gifts made by a husband and wife. Such gifts would require the dynasty trust to have Crummey provisions, which are possible albeit more complex to properly implement with a dynasty trust.

The next consideration is where the trust should be domiciled. This goes hand in hand with knowing the laws of that jurisdiction in relation to the trust's creation and administration. If the trust will be domestic, one must choose which state (of the ones that allow dynasty trusts) will be used as the trust's situs. Of the states with dynasty trust legislation, Alaska and more especially Delaware have the most favorable laws. Delaware's laws seem to be the most flexible of all the states and require the following for a dynasty trust to be valid:[324]

1) The trust must be irrevocable;
2) the trust must be a spendthrift trust;
3) the trust and its corpus must be subject to Delaware law (the trust document should state this); and
4) the trustee must be either a Delaware resident or a Delaware entity that is qualified to act as a trustee under Delaware law.

The larger question is not which state a trust should be formed in, but whether the trust should be domestic or offshore. Domestic dynasty trusts generally have the following advantages over foreign trusts:

1) They are easier and less expensive to create and maintain.
2) They enjoy simpler tax treatment.
3) Because trust assets and the trustee are within reach of U.S. courts, it's harder for a trustee to steal trust assets and abscond.

The offshore dynasty trust has its own unique benefits, which include the following:

1) If a trust is self-settled, an offshore trust will provide better asset protection than a domestic one while the grantor is alive.
2) An offshore trust may invest in attractive foreign investments that are unavailable to U.S.-situs trusts.
3) Perhaps best of all, after the grantor dies an offshore dynasty trust is taxed as a foreign non-grantor trust. This means that if the trust is created and administered correctly, trust assets will henceforth grow free of U.S. estate, gift, GST, *and income taxes* so long as the trust

does not derive income from the U.S. A U.S. beneficiary will only pay income taxes when he receives a distribution of income from the trust. However, the authors caution that the correct implementation and administration of this type of trust is very complex[325] and should not be attempted without the assistance of qualified counsel. Furthermore, there are generally no income tax advantages exclusive to offshore trusts while the grantor is alive; income tax savings are generally only possible after the grantor's death. Note that domestic dynasty trusts cannot obtain this income tax benefit.

Typically there are two factors used to answer the offshore vs. domestic situs question. The first is whether the grantor is comfortable with going offshore, and the second is whether the grantor is willing to pay the higher setup and administrative costs of going offshore. If the grantor is comfortable with going offshore, and is willing to pay the higher costs, then the long-term tax asset protection and tax advantages of an offshore dynasty trust give it a clear advantage.

In addition to jurisdictional issues, one must decide what type of dynasty trust they want. The two main types are pot trusts and generation subtrusts. Pot trusts are designed to allow multiple individuals and successive individuals to contribute to the "pot" a.k.a. the trust. The pot trust is a single trust and is easier to administer than the generational subtrust. The downside is that each beneficiary typically has an equal beneficial interest in the trust. Therefore, a distant cousin might someday have the same interest in the trust as a direct descendant of the trust's original grantor. This may discourage heirs from making additional contributions to the trust, since they may wish their lineal descendants to have a larger share of trust assets than more distant relatives.

The solution to pot trust shortcomings is to divide the dynasty trust into subtrusts each time the first member of a new generation is born or the last survivor of an old generation dies. Using subtrusts allows certain contributions to be dedicated to specific branches of future generations, which encourages successive generations to contribute to the trust. However, one may expect the number of subtrusts to grow over time, which will cumulatively add to the expense and hassle of administering this more complex arrangement.

Finally, one must draft a dynasty trust so that it may effectively handle future unforeseen challenges. Careful drafting will add needed flexibility to such a trust, and we accordingly recommend dynasty trusts contain the following provisions:

- Since certain jurisdictions do not allow dynasty trusts to hold real property, the trust should only accept personal property. The workaround for real property is to first transfer it to an LLC or LP (if its state of domicile allows for perpetual duration), and then contribute the company to the trust.

- The trustee should have the right to change the situs of the trust to another jurisdiction in the event of political instability or adverse changes in the jurisdiction's laws.
- If a beneficiary is allowed to enjoy trust property (jewelry or artwork, for example), the trust should require that person to insure the property against, theft, loss, damage, or destruction.
- The trustee should be given broad investment powers, including the right to invest internationally.
- Consider naming two or three trustees instead of just one.
- It's often a good idea to appoint one or two trust protectors (who should never be a grantor or beneficiary) who may veto trustee actions or terminate and appoint new trustees and successor protectors.
- The grantor may wish to give the trustee the power to terminate the trust if his last lineal descendant dies while leaving no specified heirs (in such an event, the trustee may have discretion to give remaining assets to a certain charity or a type or class of charities), or if the administration of the trust becomes cost prohibitive in relation to the value of trust corpus. The trust may also allow for a quorum of beneficiaries to vote to terminate the trust at some future point. Allowing for an "exit strategy" is a good idea, since it's possible at some future time the trust will no longer be desirable.

CHAPTER FIFTEEN

The Equity Stripping Strategy

Although equity stripping can be an effective (and sometimes the only) means to protect assets, it requires much skill to implement properly. Poorly designed programs are often either vulnerable to fraudulent transfer rulings, or are costly from a tax and/or economic perspective. In addition to exploring the benefits of equity stripping, this chapter seeks to identify potential flaws in certain equity stripping programs, along with creative solutions that sidestep these problems.

WHAT IS EQUITY STRIPPING?

Equity stripping is the process of encumbering an asset with one or more liens as a means of protecting the asset from future creditors. As defined by the Uniform Fraudulent Transfers Act ("UFTA"), a lien is "a charge against or an interest in property to secure payment of a debt or performance of an obligation, and includes a security interest created by agreement, a judicial lien obtained by legal or equitable process or proceedings, a common-law lien, or a statutory lien."[326] In layman's terms, this means a lien attaches to any collateral you give someone in order to ensure you repay a loan or fulfill an obligation. This includes a mortgage, deed of trust, or an agreement that uses personal property as collateral (placing a lien on non-titled property is usually accomplished by way of a security agreement; public notice of the agreement is filed with the appropriate Secretary of State's office via a UCC-1 form.) It could also be a judgment lien, tax lien, or other non-consensual lien. While you retain title and (usually) possession and enjoyment of the property, a lien technically gives its holder an ownership interest in your property. This means if you default on your debt or obligation, the lien holder may force the sale of your property at a foreclosure auction and use the proceeds to pay off the balance of the debt or obligation.

Obviously, if a creditor obtains a lien on your asset, your assets could be jeopardized. At the same time, liens can be extremely useful. This is because a properly completed (a.k.a. "perfected"[327]) lien will, with very few exceptions, take precedence over all future liens as long as it is in effect.[328] If all of a property's equity is attached to existing liens, then all future liens placed on your property will essentially be worthless to their holders. This is because there is no equity left for the subsequent liens to attach to, which means if a junior lien holder (whose lien doesn't attach to any equity) tried to foreclose, he would get nothing from the sale, since every prior lien holder would be paid first, leaving the creditor with nothing but the expenses he incurred in foreclosing on the property.

Oftentimes, equity stripping is the only viable means of protecting an asset. For example, financed property usually can't be transferred into an LLC or other limited liability entity without technically triggering a loan agreement's "due-on-sale" clause. If the clause is triggered, then the lending institution typically reserves the right to accelerate the loan, making the entire balance payable within 30 days; failure to repay the entire loan may result in foreclosure on the property. Even though lenders usually choose not to accelerate the loan if a due-on-sale provision is triggered, to be safe, you could get the lender's written permission to transfer property to an LLC or other entity. However, the Garn-St. Germain Act[329] allows us to equity strip most properties without needing a lender's permission to do so.

Another situation where equity stripping is desirable is when one is protecting their home. Under §121 of the Internal Revenue Code, a property that is a person's home for two years in any five year period qualifies for an exemption on gain if the property is sold. This exemption is $250,000 for an individual or $500,000 for a married couple. Although placing the home in a single member LLC (SMLLC) or other entity with "disregarded entity" tax status[330] will preserve this exemption, placing the home in a family limited partnership ("FLP"), family LLC ("FLLC"), or corporation will not. Therefore, it may instead be more appropriate to strip the equity to the FLP or FLLC. Also, it is usually not a good idea to hold a strictly personal asset in a business entity. The reasons for this are more thoroughly examined in the chapter "Asset Protection a Judge Will Respect".

Yet another major benefit of equity stripping is that it can be used to protect *anything* of value. For example, we could even equity strip a race horse. If a creditor then tried to seize the horse and sell it, an equity stripping program would ensure the creditor wouldn't get a dime for dong so — all money would go to the senior lien holder, which happens to be an entity that's friendly to the debtor. Thus, equity stripping can protect assets that are not only difficult or impossible to move offshore (such as real estate), but it can also protect assets that cannot easily be moved outside of a business and leased back (such as accounts receivable.)

Now that we understand the basics of how equity stripping works, let's examine programs that are vulnerable to failing under court scrutiny (the Bad), programs with painful tax and economic consequences (the Ugly), and programs that have neither shortcoming (the Good.)

THE BAD

Bogus Friendly Liens

By far the most commonly used of the flawed equity stripping strategies is the bogus lien. A bogus lien involves a friendly party (either a relative, LLC, Nevada corporation, or other entity) filing a lien against the target asset. The lien is "bogus" because the owner of the target asset receives nothing in exchange for granting the lien. In other words there is no loan or bona fide obligation as a basis for the lien. Even if there is a basis for the lien, the lien may still be bogus if its basis is much less than the lien's amount. Under the UFTA, a lien must be an amount that is of "equivalent value" to the debt or obligation.[331] What's worse, under the UFTA bogus liens fall in the category of fraud-in-fact, which is much easier to prove than constructive fraud. Consequently, although the bogus lien is easy to implement and maintain, it is also usually easy to attack and eviscerate. Should a bogus lien occur shortly before a creditor threat arises, a knowledgeable attorney should have little problem convincing a judge to invalidate the lien. Nonetheless, despite the weakness inherent in bogus liens, the fact that they are not a widely known tool means they may offer limited asset protection if they are inconspicuously implemented far in advance of any creditor claims.[332]

THE UGLY

After the Bad, we must examine the Ugly. Ugly programs usually work as far as asset protection is concerned, but they can be quite painful economically. Let's examine these Ugly programs, so that you can avoid potentially painful hidden costs and tax traps.

Tax Consequences of Certain Valid Friendly Liens

Not all friendly liens are bogus. If a friendly party gives you an actual loan that is equivalent in value to the lien, for example, and he is not an "insider"[333] as defined in fraudulent transfer law, then the lien will probably survive a court's scrutiny. However, there may still be problems with such a lien. First, you need to find a friendly person or business entity (which you may or may not have funded with your own cash) that is willing to loan you money on friendly terms. Our experience is that people generally have more wealth placed into hard assets than liquid assets. Therefore, you may find it difficult to scrape together enough personal wealth to equity strip your $500,000 home. Second, the interest payments that arise from equity stripping business assets may not be tax-deductible (especially if the equity stripping program also involves the purchase of a personal asset such as life insurance, discussed below), but they will almost certainly be considered taxable income to the lender. If you have a friend who loans you his own money, and he's genuinely profiting from interest payments, then he shouldn't mind paying the tax. However, if he intends to gift your interest payments back to you, so that you aren't losing money in the arrangement, then someone is going to have to foot the tax bill.

Finally, remember that if you receive a cash loan, you now need to protect the loan proceeds from creditors, and also make sure to structure the promissory note (a.k.a. loan agreement) so that the loan is not paid down gradually over time.

Equity Stripping via Commercial Loans: Outrageous Interest Expenses and a Possible Super-Nasty Surprise

The strength of any lien held by a legitimate commercial lender is it's practically impossible to invalidate. The weaknesses are everything else, especially from an economic standpoint. To illustrate the point, let's look at the drawbacks of taking out a 2nd mortgage to equity strip a home. In this example, the home has a fair market value of $500,000 and an existing mortgage of $200,000. The problem with taking out a 2nd mortgage to equity strip is threefold. First, commercial lenders usually only loan up to about 80% of a property's value,[334] leaving 20% of the equity exposed. Securing additional loans to completely encumber the property usually involve very high interest rates (typically 15% or so.) Second, as the loan gets paid down, the property becomes less and less encumbered and therefore more equity becomes vulnerable. Third, the cost of making interest payments on the loan can be quite expensive. For example, say you take out a $200,000 2nd mortgage on the property, to equity strip it to 80% of its value. If this was a 30 year loan repaid in monthly installments at 7% interest, you would pay $195,190.00 in interest before the loan was paid off. If you take out another loan for $100,000 in order to strip the property of all equity, you may pay 15% interest. Under the same repayment terms as before, the interest payments equal an additional $355,198.40. Inflation notwithstanding, this is a very expensive means of asset protection! Of course you could invest the loan proceeds in government bonds, annuities or life insurance, but you will still likely end up paying more than you would earn with these investments. Riskier investments (such as stocks) could provide a greater return, but you could also lose money and end up worse off than if you hadn't invested the proceeds at all.

Even from a non-economic standpoint, there are still problems with commercial equity stripping. For example, mortgages are typically paid down over time, leaving more and more equity exposed to a creditor. Furthermore, if you find yourself under creditor attack, you may very well lose the means to make loan payments. Therefore, if you don't have cash set aside outside of a creditor's reach, you may find yourself defaulting on your loan, resulting in foreclosure of the very property you were trying to protect! Although these last 2 problems may be overcome, other commercial equity stripping shortcomings may be difficult or even impossible to remedy.

Accounts Receivable Equity Stripping Through Premium Financing: Variable-Rate Loan Traps, Disappearing Tax Deductions, and So-Called "Exempt" Life Insurance Products

The concept behind accounts receivable ("A/R") premium financing for the purpose of asset protection is relatively simple. Essentially a business uses its A/R as collateral to obtain a loan, which is then used to purchase a life insurance product or annuity. Because many states protect such policies from creditors, the reasoning goes, the loan proceeds have been protected while also protecting (via equity stripping) the A/R. Furthermore, because the policy accrues interest, this helps offset the loan's interest payments.

Equity stripping in such a manner has become a very popular asset protection technique. However, the biggest reason these programs are popular is *not* because they work (although the best programs do work). Rather, these programs are popular because they are very lucrative for their promoters. For example, an asset protection planner convinces you to take out a loan for $100,000, using your A/R as collateral for the loan. Then, he tells you to invest the money in a universal life insurance policy, because your state exempts these policies from the claims of creditors, and furthermore you could always borrow cash from the policy in the future if you needed to, right? Sounds like a great way to protect your A/R? What the promoter didn't tell you is he just made between $5,000 and $55,000 in commissions from this arrangement, and although this program may very well protect your A/R from future creditors, most A/R equity stripping programs contain many traps and pitfalls. Consider the following:

- Contrary to what many believe, interest payments your company makes on a loan it took out to purchase an annuity or life insurance policy for you are often not tax deductible; you may or may *not* be able to overcome this problem if you work with a competent tax attorney.

- Almost all loans secured by A/R are variable rate loans, whereas your life insurance product or annuity generally grows at a fixed rate, or in accordance with the stock market's performance. In other words, three months after you take out your loan, you may be unhappily surprised with rising interest rates on your loan, which makes your A/R financing program much more expensive than you thought it would be.
- Although the policy you bought may be exempt in your state, if the company that sold you a policy operates in other states, then a judgment creditor could enter their judgment in a state where your policy is *not* exempt. Because the insurer operates in that state, and your policy is not exempt there, the creditor could seize your policy in the non-exempt state. You just lost your $100,000 policy, but you still have a $100,000 loan to pay off.
- Even if a certain insurance product is exempt in your state, you should be aware of whether your state has enacted fraudulent conversion laws. Fraudulent conversion law allows the purchase of a creditor-exempt asset to be voided (undone) if it was done in order to hinder, delay, or otherwise defeat a creditor. Even if the transaction would otherwise be exempt from being voided under §8(a) of the UFTA (which prohibits transfers done with fraudulent intent from being undone if the transfer was for equivalent value, and the transferee did the transaction in good faith), fraudulent conversion law would still cause this arrangement to unwind. Therefore, we especially recommend one avoid an A/R financing arrangement if they live in a state (such as Florida) that has fraudulent conversion laws and a creditor threat has already materialized.
- In some states, life insurance and/or annuities are protected *only* if the policy contains a provision exempting the proceeds from creditor attachment. Very, very few policies actually contain such language, meaning a creditor might be able to attach a policy you thought was exempt.
- Above all, remember: a life insurance agent earns commissions by selling life insurance. Some insurance agents might be more concerned with commissions than setting up a plan that's best for you.

Now we must emphasize that equity stripping A/R through premium financing is not always a bad way to go. It is sometimes possible to overcome most or all A/R premium financing shortcomings if you use a skilled planner (most aren't). *But,* considering that many people who've done this type of equity stripping were afterwards very unhappy, make sure you've addressed all the potential traps and pitfalls before committing to such a program.

If you wish to protect your company's accounts receivable, consider using a BICOCO, which we discuss in Chapter 10 of this book.

THE GOOD

Now we come to the Good ways to equity strip. We need to emphasize that even a Bad program may protect assets, and some Ugly programs can avoid their Ugliness (though most don't.) The reason the following programs are Good is because they more easily sidestep equity stripping pitfalls. However, keep in mind that proper equity stripping requires much skill, and even a Good technique can turn Bad or Ugly if done incorrectly.

As we've seen, almost anytime a lien involves cash, there tends to be several pitfalls awaiting the unwary. However, a re-reading of the legal definition of the word "lien" gives us valuable insight into how these traps may be avoided:

> "lien" means charge against or interest in property to secure payment of a debt or performance of an obligation;[335] [emphasis is ours.]

Quite frankly, it amazes us that other asset protection planners fail to capitalize on the fact that liens are commonly used to secure obligations, and that obligation-based liens are every bit as valid as debt-based liens, so long as the obligation is real, substantial, and there is a reason for it that makes sense in a business context. Of course, if an obligation is not substantial and does not make sense in a business context, then it will only be marginally better than the bogus "friendly" liens we previously discussed, as an in-depth examination may very well lead to a court's ruling that the lien is, indeed, invalid. Furthermore, it amazes us that other asset protection planners don't realize a lien securing an obligation is superior in many ways to a lien securing a loan. For example:

- There is generally no negative tax or economic consequence to fulfilling an obligation.
  - No worrying whether or not your interest payments are tax-deductible.
  - No interest expenses at all, for that matter.
  - No worrying whether your variable rate loan will exceed your fixed-rate (or risky variable rate) investment.
- It's very easy to structure a security agreement so that the lien is not reduced or paid down until your obligation is completed in full. You can even structure the agreement so that the lien *grows* until the obligation is fulfilled.

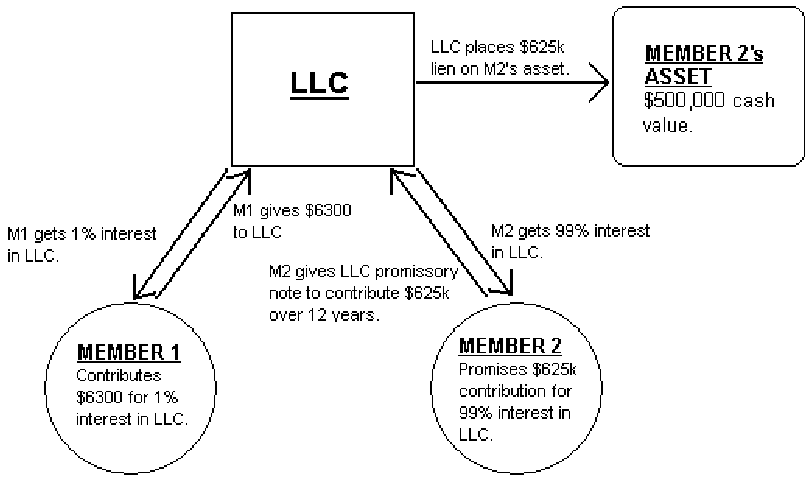
- Your secured obligation almost certainly has absolutely no value to a creditor, whereas the cash proceeds of a loan always have lots of value to a creditor, meaning you'll have to jump through more hoops to protect the loan proceeds.
- If you're in trouble with creditors, your liquid assets may be unavailable for loan payments, meaning your "protected" property is in danger of foreclosure. However, since creditor troubles should not affect your ability to fulfill non-monetary obligations, (or rather we could arrange a monetary obligation with a "friendly" entity) foreclosure is not a problem.
- You don't have to worry about "how am I going to get $625,000 to equity strip my $500,000 home?"
- Cash loans are easy to quantify, making it very difficult to justify a large lien securing a small loan. However, certain obligations can be difficult to quantify, which gives us more leeway when we are structuring an obligation to be of "equivalent value" to the cash value of a lien. [336]

With the above in mind, let's examine some ways in which a bona fide obligation may be used to place a valid lien on your property.

Equity Stripping via LLC Capitalization

One of our favorite methods of equity stripping is via LLC capitalization, a method developed to rectify the shortcomings of other equity stripping programs. The concept goes like this: two people form a Limited Liability Company (LLC) in order to run a business (which could be some legitimate, yet easy-to-do activity such as investing in stocks and bonds.) Under the LLC Acts of every state, each member (member being the LLC equivalent to partner) can obligate the other, per a written agreement, to contribute capital (assets) to the company so that it has a means to operate. One of the members contributes a smaller amount of assets up front to capitalize the company, in exchange for a small but significant ownership interest (usually 1-5%). The other member promises to make a large capital contribution over time, in exchange for an upfront large interest in the company (95-99%). Because the first member contributed his capital up front, but the second one did not, the 1st member has a valid reason for making sure the 2nd member makes good on his promises. Therefore, the LLC places a lien on the second member's property to ensure he fulfills his obligation to capitalize the LLC over time. As long as the LLC is not considered an insider under applicable fraudulent transfer law, and the obligation is valid, its fulfillment demonstrable, and it "makes sense" in a business context, a rock-solid lien has been created on the 2nd member's property. Such an arrangement is illustrated in Figure 15.1, below.

FIGURE 15.1



It's important to note in this scenario that Member 2's promised contribution could take many forms. It could be a promise to contribute cash, services, equipment, or other property. And after the lien expires, the members could dissolve the LLC and typically all returns of capital will revert back to them tax free. Furthermore, almost any type of asset could be equity stripped via this method, whether it be A/R, real estate, or personal property. Indeed, the flexibility of equity stripping via LLC capitalization is so great, that practically any type of asset could be protected, according to practically any terms that fit within the realm of normal business practice.

The Real Estate Equity Investment Strategy (REEIS)

As we discussed previously, the advantage of taking out a loan from a bank or other legitimate lending institution is it is extremely unlikely a judge would invalidate any lien used to secure that loan, regardless of whether the loan was done to delay, hinder, or otherwise defeat a creditor. The disadvantages of such an arrangement, of course, are the extreme expense associated with such (due to loan interest payments) as well as the fact that you now possess the loan proceeds, which a creditor may attach. The REEIS program largely negates both those disadvantages. It is probably the strongest of the economically viable "good" equity stripping tools available, and it is certainly the most effective program available after creditor threats have already arisen.

The REEIS program involves using an offshore entity to take out a loan, while using a client's property or properties to secure the loan. The loan proceeds are then given to the offshore entity, which then deposits them in a foreign bank CD bearing fixed interest. Because there are foreign lending institutions that specialize in REEIS arrangements, the difference between the interest rate on the loan and the fixed return on the CD is usually only 1% or less. This arrangement therefore has the following advantages:

- Because the offshore entity applies for the loan and receives the loan proceeds, the proceeds never come into the client's possession. The client is only using himself and his assets to act as a personal guarantor for the loan. This means there are no fraudulent transfer remedies available to a client's creditor if they attempt to attach the loan proceeds.
- Because the loan and CD both have fixed interest rates, there are no nasty surprises inherent to arrangements involving variable interest rates or returns. A client does not need to worry about whether the interest rate on a loan will skyrocket unexpectedly, or whether the invested loan proceeds will perform well enough in order to make the arrangement cost-effective.
- If the offshore entity is disregarded as being separate from the lender for tax purposes (which it should be) then the client may receive a partial or complete tax deduction on interest payments made on the loan. This could more than offset the income tax liability arising from the interest earned on the CD. However, one should check with a tax professional to determine whether an interest deduction is available, as circumstances will vary from case to case.
- Because the lending institution is completely unrelated to the client, and is a bona-fide institution that makes loans as a normal part of its business, it is almost inconceivable that a judge would invalidate any lien placed on the client's assets, especially in light of the good-faith transferee defense available under §8(a) of the UFTA (which we discuss in Chapter 5.)
- An REEIS program involves no ongoing obligations other than paying interest on the loan. Therefore, it is less time-intensive to maintain than an obligation-based lien.

The only downside to an REEIS program is it is generally more expensive to implement and maintain than an obligation-based lien program or an unused equity line of credit (ELOC). If there are no creditor threats on the horizon, taking out an ELOC and/or using an obligation based lien is less costly. However, once a creditor threat has materialized, any exposed equity is best protected with an REEIS program due to fraudulent transfer concerns.

The Lessor's Lien: A/R Equity Stripping Without Premium Financing Headaches

Various real estate lease agreements contain a lessor's lien clause. These liens are not part of an intentional asset protection program; rather they are liens that arise in the normal course of business. As mentioned previously, a lien may be used to ensure someone meets an obligation. In this instance, the lessor wants to make sure that the lessee fulfills his lease, so oftentimes a UCC-1 financing statement (used to perfect a lien against non-titled property) is filed against the lessee's accounts receivable, furniture, equipment, and other assets. Of course in this situation the lessor is not trying to protect the lessee's assets against other creditors, but that is exactly what he's doing.

The best asset protection planners understand how liens are used in such everyday business arrangements, and they capitalize on such processes. Utilizing a standard business arrangement for asset protection is especially desirable because it appears that no intentional asset protection was done. Because normal business arrangements often use accounts receivable to secure a lease agreement, a lessor's lien is an especially good way to protect this valuable asset.

The best type of lessor's lien, of course, is one that is held by a company who is friendly towards the lessee, because we can then draft the lease and lien terms to best suit our needs. Often times we will take property in a business, sell it to another business, and lease it back to the original business. This is called a "lease-back" arrangement, and has two benefits: first you protect one piece of property by putting it in a separate entity, and then you lease back the property to the original entity, and put a lessor's lien on a second asset. For example, an LLC could sell an office building to a 2nd LLC, lease the building back to the 1st LLC, and subsequently place a lessor's lien on the 1st LLC's accounts receivable. As simple as the concept sounds, a lessor's lien in this or similar circumstances still requires a high degree of skill to do correctly. The trick is to transfer the original asset into a separate entity in a manner that won't be considered a fraudulent transfer, among other things. Also, one must structure each entity so that they'll be respected as separate entities if challenged in court. For example, sometimes if one entity is sued, and the managers of that entity also happen to manage the 2nd entity, both entities will be considered to be only one entity under the "theory of interlocking directors." This "piercing of the veil" of the 2nd LLC will not only avail the 1st LLC's creditor of the 2nd LLC's assets, but also invalidate the reason for a lien on the company's accounts receivable. Therefore if you wish to do a lessor's lien between friendly companies, make sure you hire a skilled professional to assist you.

Multi-Stage Equity Stripping: The Solution to Traditional Equity Stripping Shortcomings

Despite the advantages of equity stripping via LLC capitalization and the lessor's lien, these programs may not completely meet an individual's needs. For example, if an individual wanted to protect their $500,000 free and clear home, they would have to promise a large capital contribution of either services or cash to the LLC. Honoring such an obligation might not be desirable. Furthermore, if the person who held the obligation manages the LLC, then the LLC that holds the lien would be considered an insider under fraudulent transfer law. Although this does not necessarily mean a fraudulent transfer has occurred, it may somewhat reduce the lien's chance of survival if its validity was challenged. Fortunately, multi-stage equity stripping allows us to overcome these obstacles.

Multi-stage equity stripping is simply the process of placing two or more liens on a piece of property. If the target property is real estate (the most common equity-stripped asset), we most often have a client use the property to obtain an Equity Line of Credit (ELOC). The benefits of an ELOC are fourfold. First, although the lien is filed when the ELOC account is opened, one need not pay interest or other fees until the ELOC is actually used. Only under severe creditor duress does the ELOC even need to be exercised.[337] Second, oftentimes homeowners wish to "un-trap" equity in their homes, so that they may invest the proceeds for profit.[338] An ELOC is an ideal means of doing this. Third, an ELOC can continuously strip a target property of 75% or so of its equity. Unlike a traditional mortgage, which will gradually be paid down, one can choose to only pay interest on the ELOC (or, if principle payments are required, then the repaid principle could be taken out again), thus ensuring, if necessary, that an increasing amount of equity will not be exposed to creditors. Furthermore, because much of the equity is stripped via an ELOC, it is easier to strip the remaining equity with an equity stripping via LLC capitalization program. Finally, even if a less than ideal (strength-wise) equity stripping via LLC capitalization program is used, from a creditor's standpoint the program will only attach to the least desirable equity. This is because if a creditor forecloses on a debtor's real property, the property will likely only sell for 60-80% of its fair market value. Because the ELOC typically covers this equity anyway, and the ELOC has virtually no chance of being undone by a court, the creditor has little incentive to challenge the 2nd lien. Despite this fact, we still wish to place the 2nd lien on the property, to cover its equity in case the property appreciates, or if in the future the owner decides to sell the property for fair market value while a junior judgment or other "hostile" lien is encumbering the property.

How Equity Stripping Works When Creditor Threat Arises

Implementing the best program for your situation is not all we must know in order to protect assets via equity stripping. We must also know what to do if a judgment or other non-consensual lien, such as a federal tax lien, attaches to equity stripped property (hereinafter we'll include all such liens when we use the term "judgment lien"). Although a judgment lien may not attach to any actual equity, if we ever sell the property, the lien may follow the sold property afterwards. Since prior liens are usually paid-off at the point of sale, this means that these hostile liens could then be the first liens on the property once the buyer acquires it! Of course this would be unacceptable to the buyer, as well as to any institution that might finance the purchase, so before selling this property, we must get rid of all hostile liens. This is accomplished by having our friendly lien foreclose on the property. Foreclosure, of course, is only necessary when you want to sell equity-stripped property that has junior hostile liens on it. Often a favorable settlement is reached prior to this occurrence, and thus the hostile lien is removed and foreclosure is not necessary.

Before discussing foreclosures, we must warn that *not all states treat foreclosures identically*. Therefore, checking with a local attorney is a *must* before foreclosing. With that in mind, foreclosures typically happen one of two ways: by judicial foreclosure, or by a private party foreclosure. The type of foreclosure depends on the type of lien filed against the property. If the lien is a mortgage, then foreclosure occurs under court supervision. A deed of trust is foreclosed without court oversight. Obviously, a deed of trust is easier to foreclose, since it doesn't involve the court, and therefore a deed of trust should be used as the lien document of choice whenever possible. Regardless, however, expect to pay $2,000 to $5,000 to for the entire foreclosure process.

The foreclosure process usually requires posting at least a couple public notices of such in a local newspaper or other publication, and it can take anywhere from three to six months from its inception before the actual auction occurs. The auction will typically be held by the deed trustee if the lien is a deed of trust, or a sheriff if the lien is a mortgage. When a foreclosure sale is held, the minimum bid is usually the amount of the lien that is being foreclosed. The winning bidder must pay at least this amount, or more, if he bid above the minimum. However, when the bidder acquires the property, it is still subject to senior liens. For example, if we have a $500,000 home with a $400,000 1st mortgage and a 2nd lien (which is our equity stripping program) on it for $250,000, and the 2nd lien forecloses, the bidder must pay at least $250,000 and he still pays on the $400,000 mortgage note after he acquires the property. Any liens junior to the foreclosing lien, however, are wiped out, and the buyer has no obligation to pay them.

Obviously, in our preceding example the buyer would not be getting a good deal. He'd pay at least $250,000 for a $500,000 piece of property, but he'd still have to pay off the $400,000 1st mortgage. This begs the question "what happens if no one bids at the auction, since doing so may not be a good deal?" In this case, if there are no bidders, then the lien holder who foreclosed becomes the new owner of the property, which is still subject to senior liens but free of junior liens. If this lien holder was an entity friendly to the property's owner, it could then sell the property, and sale proceeds would flow into that LLC, thus remaining out of creditor reach. Careful planning would even allow us to restructure the entity so that the Internal Revenue Code §121 exemption[339] on gain upon sale of a personal residence is allowed when the property is sold.

In summary, although equity stripping requires great skill to do correctly, creative and knowledgeable planners should have no problem finding an effective equity stripping method that meets their clients' needs while minimizing the expense and effort involved in maintaining such a program.

CHAPTER SIXTEEN

Investing Offshore to Protect and Grow Wealth in Perilous Economic Times

What a shame it would be to go to a planner and spend thousands of dollars on a competent asset protection and integrated estate plan, only then to lose the majority of your wealth to a severe economic downturn or other such crisis. For this reason, we the authors strive to implement plans for our clients that are reinforced against *all* threats to one's wealth, not just lawsuits and estate taxes. This is why we have included this most important chapter in our book.

Over the last decade or so, we have observed an interesting trend with offshore planning. Beginning in 1998, a few offshore asset protection trusts (OAPTs) failed when challenged in court.[340] Consequently, the trust's grantors were incarcerated for failing to repatriate trust assets to the U.S. These cases, along with stricter federal reporting requirements and the IRS's efforts to prosecute anyone suspected of using offshore entities for tax evasion has led some to unwind their offshore structures. As a result, although there remained a demand for offshore planning, this demand lessened and partially shifted to domestic solutions.

In the past few years, however, we have seen a renewed interest in going offshore. Yet this time the interest in offshore planning is more motivated by economic reasons, with asset protection as an equal or sometimes even secondary objective. This chapter examines the reasons for going offshore, the fundamental aspects of offshore structures (and their various pros and cons), and foreign investing (including foreign insurance as a gateway to foreign investing).

The advantages gained through offshore planning can be summed up as follows:

- Enhanced asset protection,
- Greater investing and profit opportunities,
- A safeguard against market downturns, and
- A safeguard against the weakening U.S. dollar (inflation or hyperinflation).

Before we examine the benefits of offshore planning, however, we will first examine the greatest and most dire threat to the wealth of every American. Minimizing the effects of this threat is the most pressing reason for going offshore.

The U.S. Economy's Time Bomb

The 2008 credit crisis has made most Americans aware of what a select group of experts have known for years: the U.S. economy is in deep trouble, far beyond that of a normal cyclical downturn. Many consider the 2008 financial crisis, which led to the failure, bankruptcy, or near-failure of some of our nation's oldest and largest financial institutions (Fannie Mae, Freddie Mac, AIG, Lehman Brothers, Washington Mutual, Citigroup, Wachovia, Bear Stearns, Morgan Stanley, et al), to be the worst financial crisis since the Great Depression.[341] Warren Buffet and other noted luminaries have expressed fear that the crisis could deepen into a nationwide "financial meltdown".[342] The managing director of the International Monetary Fund (IMF) has even stated that "Intensifying solvency concerns about a number of the largest U.S.-based and European financial institutions have pushed the global financial system to the brink of systemic meltdown."[343] Translation: the 2008 credit crisis almost caused a system-wide collapse of the global financial system. If the 2008 crisis almost caused a collapse, that means an actual collapse could happen in the future. This is a contingency we must prepare for.

Notwithstanding the seriousness of the 2008 crisis, it is but a faint shadow of what's to come. If this crisis could be compared to a category 1 or 2 hurricane, the financial hurricane that will probably hit us sometime next decade will be a Category 5 Storm of the Century. Unfortunately, many Americans are completely unprepared for the coming super-storm. They can, however, prepare at least somewhat if they act soon. For the high net-worth individual, moving wealth offshore and out of the dollar will likely be a key component of this preparation. But before discussing possible solutions, let's first thoroughly examine the problem.

A few years ago, those brave enough to warn of hyperinflation or another possible Great Depression were often laughed at and ridiculed by their colleagues. Even as recent as January 30th, 2008, Citigroup director Robert Rubin said the subprime lending woes were "all part of a cycle of periodic excess leading to periodic disruption," and that no meltdown was likely.[344]

Today, thanks to the financial crisis of 2008, which materialized after all (much to Mr. Rubin's surprise), people are no longer laughing when someone mentions the possibility of an economic meltdown. Those once scorned as "wackos" and "doomsayers" are now considered financial prophets. Yet as sobering as the 2008 crisis may be, many analysts' projections for the next decade are much, much worse. According to David Walker, who was until recently the U.S. Comptroller General, the impending disaster arising from our government's financial problems will be many times more severe than the 2008 crisis:

> "People seem to think the government has money… the government doesn't have any money… The factors that contributed to our mortgage-based subprime crisis exist with regard to our federal government's finances… The difference is that *the magnitude of the federal government's financial situation is at least 25 times greater*." — David Walker, 7/17/2008 [emphasis is ours]. [345]

25 times greater than the 2008 crisis? One may find that hard to believe, much less comprehend. But before planting your head in the sand and writing off Mr. Walker as a raving lunatic, consider this: until 2008 Mr. Walker was the federal government's chief accountant. If anyone is qualified to talk about our government's financial state, it is him. Furthermore, he is not the only respected individual who's sounding the alarm. We highly recommend everyone watch the 2008 documentary I.O.U.S.A.[346] — it's perhaps the scariest film ever made. It features commentary by multi-billionaire Warren Buffett, former Federal Reserve chairman Alan Greenspan, former U.S. Treasury Secretary Paul O'Neill, U.S. congressman Ron Paul, former Federal Reserve chairman Paul Volcker, and Bob Bixby of the Concord Coalition. It is a must-see.

The underlying premise behind this movie is that federal entitlement programs such as Medicaid, Medicare, and Social Security (which comprise almost 40% of all federal spending) will, in the next decade, spiral hopelessly out of control. The 2008 $700 billion bailout (only one of several bailouts that total over *$7.7 trillion*[347]) and the cost of the Iraq War further exacerbate the matter. Nevertheless, the worst culprit by far is entitlement spending. Entitlement spending woes arise largely because of a demographic anomaly known as the baby boom generation. This term refers to a period in U.S. history marked by a sharp increase in births arising from unprecedented economic prosperity. The bad news is, as of 2008, the baby boomers became eligible to collect early retirement benefits, and a few years later they'll be eligible to begin collecting full benefits. What does this mean to the federal budget? As popular CNN commentator Glenn Beck puts it, it means a $53 trillion financial "asteroid" will hit us sometime next decade. Mr. Beck refers to this threat as an asteroid because, just like an asteroid hitting earth could wipe out all life on the planet, this asteroid could wipe out all wealth in the U.S.,[348] something not even the Great Depression managed to do.

Specifically, this asteroid arises from, according to the 2007 Financial Report of the United States, "[the] federal government's total liabilities and unfunded commitments for future benefits payments promised under the current Social Security and Medicare programs".[349] Note that in the 2000 report, these obligations were a "mere" $20 trillion.[350] If these obligations grew by $33 trillion in only 7 years ($8 trillion because of so-called "conservative" President George W. Bush's signing of the Medicare-D prescription medication program into law), how much will they grow in the future?

What will happen when this asteroid hits? No one can say with 100% certainty. However, if history is any indicator we have a good idea of what will probably occur: stagflation (severe inflation in a recession or depression) or more likely hyperinflation coupled with an economic collapse and the federal government's bankruptcy.

Historical examples of hyperinflation abound. Take post-WWI Germany, for example. The German government had massive reparation debts to pay as a result of the war. Initially inflation was not an insurmountable problem, with the German mark holding somewhat steady at around 60 marks per U.S. dollar through the first half of 1921 (note however that the ratio of marks to dollars in 1914 was only 4.2 to 1). However, the "London Ultimatum" of May 1921 made things much worse, due to the fact that it demanded, beginning August 1921, annual payments of $2 billion gold marks plus 26% of the value of Germany's exports.[351] Germany had nowhere near enough money to make payments under such a plan, which was supposed to last until 1984, so it printed massive amounts of fiat currency. This started a severe inflationary trend. This resulted in the citizenry's loss of confidence in their currency, which caused a panic and led them to dump their marks as quickly as possible by purchasing and hoarding living necessities. This in turn caused a shortage of living necessities, which in turn led to even higher inflation as the result of the greater demand, which led to more hoarding, and so on. The end result was hyperinflation. Consequently, by December 1923 the mark had devaluated so much that the mark to U.S. dollar ratio was 4.2 *trillion* to 1.[352]

Hyperinflation is not unique to Germany, as there have been 22 other countries that have experienced this crippling phenomenon just since 1970. In every case, the government in question had the power to print unlimited amounts of money and was burdened by crippling debt.

Will a $53 trillion unfunded obligation lead our government to attempt to cover that obligation by printing inconceivably massive amounts of paper money? What will the affects of this $53 trillion debt (which includes our "official" national debt of $10.27 trillion),[354] the cost of the Iraq War, and the $8.5 trillion 2008 bailouts? Would the foregoing lead China and other countries to dump their multi-trillion U.S. dollar holdings, which would in turn lead to a loss of the U.S. dollar's status as the world's reserve currency, thus greatly devaluing the dollar even further? Time will tell for sure, but if history is any indicator, the answer to at least some of these questions is almost certainly yes, and a "yes" answer to any of the above means disaster and hardship of a biblical scale.

The effects of hyperinflation are devastating. Essentially, a national population's savings and retirement are wiped out. This means IRAs, 401(k)s and other pensions or retirement funds become practically worthless, because the dollar they are based on becomes worthless. Furthermore, hyperinflation typically leads to hording of commodities such as gold, silver, fuel, and food, along with a system-wide financial panic and usually a depression or extremely deep recession. This involves a massive sell-off of other non-essential liquid assets in an attempt to purchase those commodities, which are then used for bartering since the currency is now all but worthless. There goes your investment portfolio, along with the stock market in general.

Some may argue the U.S. stock market will not disappear and that, although stocks may plunge in value during a crisis, one can eventually ride out the storm and emerge in as good or better a position than before. To this idea we would caution: remember the Great Depression. The Dow Jones Industrial Average (DJIA) was 380 points at the end of August 1929, right before it crashed. It wasn't until November 1954, over 25 years later, that the DJIA recovered to 387 points. These numbers don't account for the 25 years of inflation that occurred in that same period, meaning a true recovery took several years longer. If you're thinking about beating an economic meltdown by holding onto your U.S.-based portfolio, ask yourself whether you can risk waiting 25 years or more for things to get "back to normal".

Another argument that may be made against future inflation of the dollar is that at the time of this writing (late 2008) the U.S. dollar has strengthened significantly. Do not be fooled by this temporary rally. If we look at the simple supply and demand model most fundamental to modern economics, we can easily see why the dollar has behaved as it has. The dollar's rally is due primarily to the credit crisis. The credit crisis of course has resulted in people and businesses having great difficulty getting loans. Since the dollar is a debt-based currency,[355] the lack of available credit means there is a shortage of supply in dollars. Because dollars obviously remain in demand, a shortage of supply means the "price" of the dollar rises, i.e. the dollar strengthens. However, it is not a projection but an actual fact that the Federal Reserve and the U.S. government are injecting trillions and trillions of dollars into the economy via bailout programs. These injections are already occurring, but they will not all occur within a few weeks or even a few months. However, they will occur and in time their effects will be felt. Injecting the $14 trillion U.S. economy with $8.5 trillion or more in cash is almost certain to not only rectify the credit crisis, which will lead the dollar to continue down its usual path of weakening against other foreign currencies, but it will also greatly dilute the purchasing power in our economy, since there is no way our economy will grow 60% to match the 60% of extra cash that will be introduced into the monetary system.

So how does one minimize the effects of hyperinflation, a severe U.S. depression, or other problems that may arise from the coming super-storm when it hits? The short answer is to get your wealth out of the dollar and as far removed from the U.S. economy as possible. There are several ways to do this:

- Invest in direct ownership of select commodities, especially food and fuel-based commodities.
- Invest in gold, silver, and possibly other precious metals.
- Invest in stable foreign currencies (often referred to as *safe currencies*, *hard currencies*, or *strong currencies*).
- Invest in stable foreign markets.

Your offshore planner and/or an investment advisor who specializes in foreign investing can help you invest in both stable foreign currencies and equities, as well as protect your investments in the event of a national or global market meltdown. We'll discuss how to do this shortly.

Using Precious Metals to Safeguard Wealth from Hyperinflation and Economic Collapse

Because other countries have already faced the same challenges the U.S. will someday face, we know how to safeguard against hyperinflation, an economic collapse and other associated threats.

Investing in gold and silver as a hedge against a weakening dollar is always a good idea. Those who buy gold and silver now stand to reap enormous profits when it is hoarded during an economic collapse and/or hyperinflationary period; they will do even better if the post-hyperinflation replacement currency is backed by precious metals. Having an emergency supply of food and water is also smart.

But what if we face a repeat of 1934, when all gold was confiscated under the orders of President Roosevelt? What if this confiscation includes silver as well? Though we can't say for sure whether something like this would occur, it's already happened once in our nation's history and therefore remains a possibility.

Risk of confiscation notwithstanding, it's still a good idea to always have some physical gold or silver on hand and easily accessible. However, most of one's precious metals portfolio should be held outside the U.S. to avoid risk of confiscation. The safest way to do this would be to hold precious metals in a secure offshore location like the Perth Mint.

The Perth Mint has existed for over 100 years and is fully backed by the government of Western Australia. It is the only government-backed vault of its kind in the world. With a minimum $10,000 investment, plus a small administrative and service fee, you may purchase gold, silver, and platinum directly from the mint at spot price and store the metals on site at no extra charge. Deposits are held in a maximum security vault and insured by Lloyd's of London. Because precious metals mining is such an integral part of that region's economy, unlike in the U.S. it is extremely unlikely precious metal ownership will ever be outlawed in Australia.[356]

A 2nd option is *Goldmoney.com*, which is headed by the highly respected precious metals broker James Turk. Purchases and sales of precious metals may be done online. Your precious metals are directly owned by you and held in secure vaults in Zurich and London. As with the Perth Mint, all vault deposits are insured by Lloyd's of London.

A 3rd option would be to invest in mining stocks, but this option is for the speculator rather than the conservative investor. Regardless, when precious metal prices skyrocket certain mining stocks' values will increase exponentially. Just remember that with greater profit opportunities often comes greater risk.

When all is said and done, however, one should never hold an offshore precious metals account in one's own name. As we discuss in the following chapter, all it takes is a repatriation order and your wealth will effectively again be in a U.S. judge's and/or creditor's reach. Failure to comply with the order will likely lead to civil contempt and incarceration. The next chapter demonstrates why owning offshore assets are best accomplished via an offshore LLC or other structure where the entity's management and at least some member voting rights are also located offshore. This will preclude a judge from being able to order the manager (or trustee in the case of a trust) to repatriate assets. Placing at least some of the entity's ownership offshore also ensures the judge cannot force the offshore structure's owners to replace the offshore manager with a court-appointed receiver. The most asset-protected structure will own a foreign insurance policy that in turn will own the precious metals and other investments. We'll discuss foreign insurance later in this chapter.

As a final note regarding precious metals, we recommend in most cases you avoid Gold Exchange Traded Funds, or GETFs. Among other reasons, GETFs are a form of unsecured bond. This means that if the institution that issued the bond fails, the bond may then be worth little or nothing. Learn from the Lehman Brothers failure! Those who held bonds and other debentures issued by Lehman Brothers lost all or nearly all of their investment. There are a few upsides to GETFs. For example, you can short-sell a GETF, which is something you could never do with physical gold. Nonetheless, in light of these perilous times the benefits of GETFs generally do not outweigh their risk. If you do buy GETFs, make sure you are 100% confident in the issuer's immediate and future stability.

The Grass Really is Greener on the Other Side: the Safer and More Profitable Foreign Markets

A wise investor does not invest outside of the U.S. only as a hedge against inflation or other domestic financial downturn. Going global presents a plethora of enhanced investing opportunities that allows one to maximize profits. While ownership of precious metals is a good idea, one should also diversify their portfolio by investing in foreign stocks and other equities that are based on sound foreign currencies such as the Swiss Franc. Doing so provides the following benefits, each of which we'll discuss in more detail afterwards:

- For almost the last decade, foreign investments have significantly outperformed U.S. markets; see Table 16.1 for a comparison of U.S. vs. foreign markets and currencies.
- As we'll discuss shortly, **even the U.S. government admits that by 2025 there will be a significant shift of wealth from the U.S. to China and other Asian countries**.[357] Those who follow the money as it shifts from West to East will reap the benefits!
- Many foreign currencies inflate much more slowly than the dollar. They are also much more stable and are therefore not at risk of hyperinflating. For example, since 1993 the Yen's average annual inflation has been practically zero, and the Swiss Franc's average annual inflation rate has been just over 1%.[358] If you invest in stocks and other equities based in these markets, you benefit from this low inflation by realizing returns in a currency that has stronger purchasing power. Plus, the equities will generally appreciate over time to grow one's wealth as well as negate the (lower but still present) effects of inflation affecting the underlying currencies.
- Smart investing in select foreign equities will help preserve or even grow wealth in the likely event that a U.S. economic collapse has a short term adverse affect on the global economy.

Foreign Markets Have Outperformed U.S. Markets So Far This Decade

Contrary to the belief of many, the U.S. is not always the best market for investors. This holds especially true over this last decade. Table 16.1 (below) compares the performance of various markets, currencies, and precious metals during a six year period ending October 31st, 2007.

TABLE 16.1: Performance Comparison of Various Market Indexes, Precious Metals, and Currencies 10/31/2001-10/31/2007

	10/31/2001 Values	**10/31/2007 Values**	**% Gain Between 10/31/01 and 10/31/07**	**Average Annual Return Between 10/31/01 and 10/31/07**
Dow Jones IA Index	9,323.540	13,595.0996	45.81%	6.5%
S&P 500 Index	1,087.20	1,509.65	38.86%	5.6%
NASDAQ Index	1,745.73	2,810.3799	60.99%	8.3%
Gold (Price Per Troy Oz.)	$277.86	$789.35	184.08%	19.0%
Silver (Price Per Oz.)	$4.21	$14.32	240.14%	22.6%
Swiss Franc (Value in U.S. $)	$0.61152	$0.86282	41.09%	5.9%
Euro (Value in U.S. $)	$0.89923	$1.4467	60.88%	8.3%
MSCI EAFE [369] Global (Non-U.S.) Index	1,108.338	2,388.737	115.52%	13.7%
MSCI Emerging Markets (EM) Index	266.861	1,337.630	401.25%	30.8%

As we can see, in the above timeframe referenced in Table 16.1, one would have done better by converting dollars into Euros or Francs held in a non interest-bearing bank account than by investing in the S&P 500. Investing in Gold or Silver would have brought even greater returns, but the greatest returns were realized in the MSCI EM Index: 30.8% average annual gains! Of course, no market is eternally bullish. Silver and gold have peaked several times in the past only to decline sharply. The MSCI EM market has declined over 47% in 2008 (but if one invested in it in 2001 and remained there through October 2008, they'd still have realized annual gains of about 15% - far greater than S&P 500 or DJIA gains). To realize profits, one still has to know what they're doing, or hire someone who knows what they're doing. Nonetheless, the following point remains valid: going global presents one with greater profit-making opportunities. And, as we illustrated earlier, the best opportunities will likely not be found in U.S. markets for quite some time.

It is fortunate that a bear market in the U.S. is often not reflected in the performance of other markets. More often than not, many foreign markets are only minimally affected or even run counter-cyclical to a U.S. bear market. Table 16.2 illustrates this point; we see how between 1/1/1973 and 9/30/1974 U.S. markets declined sharply. In contrast, during this period Swedish markets were almost flat, Spanish markets realized modest gains, and Austria realized significant gains. In fact, between 1972 and 1980 the yen more than doubled its value against the dollar, and the Deutsche mark and Swiss franc almost tripled. Going abroad in any of these markets during the 1970's practically guaranteed you'd have done much better than had you kept your wealth in the U.S.[360]

Table 16.2: Performance Comparison of Various National Market Indexes 1/1/1973-9/30/1974

Index	Value as of 1/1/1973	Value as of 9/30/1974	% Gain or Loss
Dow Jones IA	1047.49	584.56	-44.19%
S&P 500	119.87	62.34	-47.99%
MSCI Austria	149.009	181.091	+21.53%
MSCI Spain	155.575	171.392	+10.17%
MSCI Sweden	114.193	113.316	-0.77%

Go East, Young Man! The U.S. Government's Shocking Admission Regarding the Global Transfer of Wealth

We've all heard the saying that when one door closes another opens. We've also heard that one man's misfortune is another man's opportunity. Both of these sayings apply to the transfer of wealth from the West to East that we are now experiencing. The misfortune in the U.S. will, in the long term, result in increasing wealth throughout Asia. Likewise, while the door of profit-making opportunities is closing in the U.S., it is opening abroad, especially in certain Asian markets. We expect this trend to continue for at least the next two decades. What's shocking is the U.S. government actually admits this is occurring. In November 2008, the U.S. National Intelligence Council (NIC) issued a report called "Global Trends 2025: A Transformed World". This report, among other things, forecasts a decline in U.S. power and a shift in wealth and economic prosperity to the East,[361] especially to China, which the report predicts will be the world's 2nd largest economy by 2025.[362] Another nation the report singled out for most likely continuing "to enjoy relatively rapid economic growth"[363] is India. A third trend this report identifies is a continued increase in demand for energy, food, and water resources due to continued population increases and economic growth. Most of this economic growth (and corresponding increased purchasing power and demand for resources) will come from an expanding global middle class that's expected to grow from 440 million people to about 1.2 billion by 2025. The report predicts most of this new middle class will be created in China and India. [365]

Some of us after reading this will undoubtedly shake our heads and wonder how America could ever lose such a prominent economic position in the world. After all, America used to the world's largest creditor nation and foremost producer of low cost, high quality goods, while still managing to pay the world's highest wages. Unfortunately, our great country has been severely crippled by many factors, which include:

- Heavy taxation. As of 2006, we have the world's 2nd highest corporate tax rate.[366]
- Overregulation. 15% of our entire economy is dedicated to ensuring legal and regulatory compliance (this does not include tax payments, although it does include the cost of preparing tax returns.)[367]
- A huge national debt and other obligations, which we examined earlier in this report. The more money that is tied up or owed by the U.S. government, the less there is available for growth in the private sector. In fact, only 42% of the U.S. economy is now used in the private sector. The rest goes to taxes or to ensure legal and regulatory compliance.[368]
- Litigation costs. The U.S. tort system is the most expensive in the industrial world. U.S. tort costs are 2.2 percent of our gross domestic product (GDP) — 244% that of other advanced industrialized countries.[369] Dynamic and static costs of litigation in the U.S. are an estimated *$865.37 billion dollars* each year![370]
- National trade deficits. Our trade deficit was $711.6 billion in 2007 — the largest in the world.[371] U.S. trade deficits, which began in the 1970's and have since then progressively widened, are the primary reason Warren Buffett, for the first time in his 72 years, in 2003 began investing significant amounts of Berkshire Hathaway (BH) holdings in foreign currencies.[372] Since then he has progressively diversified BH holdings into foreign economies,[373] and has even on occasion shorted the dollar — essentially he bet that the dollar would decline in value versus one or more foreign currencies, and it did!
- All of the above has severely reduced the dollar's purchasing power, forced American families to either lower their standard of living or work longer hours and take on more debt, or all of the above. It has furthermore forced our factories and manufacturers to move to more business-friendly, low tax, minimally regulated environments, such as China, India, or Central or South America. In the last few years even our jobs have started to move overseas via "outsourcing".

We the authors are patriotic individuals who love America. It therefore pains us to point out the irony that "communist" China has in the last couple decades experienced enormous economic growth by adopting policies of economic freedom, private property ownership, minimal regulation, and low taxation that our "free" country has progressively abandoned. And yet most Americans are unaware that Chinese citizens enjoy a far lower overall tax rate and experience greater economic freedom than we do domestically (although, at least at the time of this writing, we generally enjoy a higher standard of living.). Nonetheless, facts are facts, and we may either ignore the facts and suffer or use them to our advantage by placing our wealth offshore, where the greatest profits will most likely be made.

Using Foreign Insurance for Greater Asset Protection, Tax Savings, and Enhanced Investing

As asset protection planners, we don't usually take a client's wealth offshore without placing it in some type of *insurance wrapper*. An insurance wrapper is a term that refers to an insurance policy used as a vehicle or "wrapper" for other non-insurance purposes. In the offshore context, properly utilized insurance wrappers are very useful and have several benefits. First and foremost, foreign insurance wrappers give us a reason for why we take assets offshore. This is important because, in an asset protection context, it is always critical to have a reason for *doing* something other than just asset protection. The best plans have asset protection as an incidental benefit rather than a perceived primary objective. This is true even if asset protection is actually in fact the main reason for implementing the plan. This is due to certain nuances of fraudulent transfer law. Fore example, there have been court cases where a defendant stated that the primary purpose for their trust, LLC, or other structure was asset protection, and the courts ruled this *ipso facto* meant that any transfer into the structure was fraudulent.[374]

Therefore, when a judge asks why you took $10 million offshore, the last reason you want to give is that you did it to thwart creditors. Foreign insurance policies are a good alternative reason for setting up an offshore entity because foreign insurers almost universally refuse to deal directly with a U.S. citizen. Instead one must set up an offshore structure and use it to buy the policy, which gives us a good non-asset protection "cover story" for why we set up an offshore trust, LLC, or other offshore entity. Putting cash in an offshore structure that then purchases foreign insurance also avails us the §8(a) UFTA defense against fraudulent transfers — a very important defense if assets are taken offshore after creditor threats have already materialized. We discuss using foreign insurance wrappers to avoid fraudulent transfer rulings in this book's chapter on fraudulent transfers as well as the chapter "Asset Protection a Judge Will Respect."

If we take assets offshore to buy foreign insurance, the next question we must ask is why would we buy foreign insurance in the first place? Why not just stay domestic? The short answer is a foreign insurance policy is a gateway to access international investments. Many of these investments are not available to U.S. persons, because most foreign securities are not registered with the SEC, and most foreign broker-dealers do not want to risk becoming subject to U.S. regulations and taxes. If a foreign insurance company buys those investments within a policy that is owned by your offshore structure, however, then the foreign dealers will have zero exposure to U.S. regulations.

As we've seen thus far, getting out of the dollar and into foreign equities and strong foreign currencies is not only safer (in the long run) than staying in the dollar, but doing so also provides enhanced profit opportunities. After all, there's almost always a bull market somewhere in the world, even during a U.S. bear market, and many international markets show greater returns than U.S. markets, even when domestic markets are performing well.

Using a foreign insurance wrapper for international investing often provides tax benefits as well. For example, if a U.S. person directly purchases foreign mutual funds, these funds will usually be taxed according to §1291 of the Internal Revenue Code (IRC). Under IRC §1291, the best case scenario is you'll be taxed at the highest ordinary income tax rate. The worst case scenario, depending on how long you hold on to the security, is you may pay a tax as high as 84%! The good news is investing through an insurance policy will legally avoid the heavy §1291 tax rates.

Furthermore, as with domestic insurance, offshore insurance may provide for tax-deferred or tax-free growth. For example, investments held in a foreign variable universal annuity (VUA) are tax-deferred until annuity payments are made (for individuals who want a guaranteed return, fixed rate foreign annuities are also available). Therefore, even if investments within the policy are sold, no tax is triggered if there is no annuity payout. Payouts or loans from foreign variable universal life policy (VUL) are tax free, and unlike with domestic VUL policies, annual returns of 10% are commonplace, and annual returns in excess of 20% are not unheard of. Many wealthy individuals use VULs for retirement income. If they borrow from the policy's cash value (which grows according to the performance of invested premiums), the loan does not have to be repaid and is subject to very low interest (2% or so). If the loan is never repaid, the only consequence is a decreased death benefit. Using foreign VULs in this manner thus provides tax-free income in a heavily asset-protected foreign structure that is not subject to the ups and downs of a U.S. market or the progressively weakening dollar.

There is one other type of foreign policy we need to mention: the foreign portfolio bond. A foreign portfolio bond is ideal for an individual who wishes to invest internationally without having to wait until an annuity or other policy's payout period begins. The portfolio bond basically allows the insurance company to invest your wealth on your behalf so that you may access the widest range of foreign investments possible while being able to withdraw profits at any time. Portfolio bond investment gains are taxed as ordinary income and are not tax deferred, but this is offset somewhat by the lower overhead usually associated with this type of product. With many portfolio bond policies, administrative fees will drop to a nominal amount after a certain period (8 years or so).

As with many asset protection tools, foreign insurance policies have their cons as well as their pros. The first con is a one time, 1% excise tax that must be paid when any premium payment is made on a foreign policy. This payment should be made along with filing IRS form 720. A 2nd potential con, which applies to all policies except life insurance (which is income tax free), is that investment gains are taxed as ordinary income and not according to the lower 15% capital gains rate. This may be somewhat offset by the tax-deferred nature of a VUA policy, of course, but the higher rate should nonetheless be considered.

One should also pay attention to a policy's *surrender value*, which is a monetary penalty for withdrawing policy funds prematurely. Furthermore, one should be aware of administrative and other fees charged by the insurer, as well as management fees if an investment manager is used.

Finally, foreign insurance policies typically have minimum funding requirements of at least a couple hundred thousand dollars, and are therefore more appropriate for the middle-upper class or high net worth individual. For those who are not able to make the minimum premium payment, there are other options. There are foreign stocks available through U.S. broker-dealers, although the selection is fairly limited relative to what's available through a foreign insurance wrapper. Furthermore, foreign currencies may be bought and sold via a FOREX (foreign currency exchange) account, and one may of course purchase hard assets such as precious metals, real estate, and certain commodities that, unlike the U.S. dollar or domestic securities, are not at risk of being wiped out during an economic crisis.

The Writing is on the Wall

In summary, the evidence is overwhelming that it is now more dangerous to leave one's wealth in the U.S. than to take it abroad. Furthermore, greater profit opportunities exist in foreign markets than will exist in the U.S. for quite some time. In addition, one will greatly benefit from enhancing their portfolio with direct ownership of precious metals (the bulk of which will preferably be located offshore) as well as food, energy, and other commodities. Finally, don't forget to put everything in an asset protected offshore structure so that you may retain ultimate beneficial ownership even if a creditor threat or national emergency arises.

Despite the overwhelming evidence supporting the arguments made in this chapter, we understand many readers may be reluctant to suddenly invest most or all of their wealth in foreign markets and currencies. After all, doing so is an enormous transition, and the mechanics and ramifications involved will likely be unfamiliar to you. To this we say: start small and gradually transition more and more into foreign investments as your comfort level with doing so increases. You may even want to keep some of your wealth permanently in the U.S. Ultimately it's up to you to decide where to allocate your investments. At the very least, however, we recommend you continue to study and learn more about the topics we've discussed in this chapter. You will be glad you did, and your long-term financial survival may very well depend on doing so.

The writing is on the wall and the message couldn't be clearer. Heed the warning.

CHAPTER SEVENTEEN

Offshore Planning Fundamentals

Going Offshore for Enhanced Asset Protection

In the 1990's, going offshore was almost synonymous with asset protection. There was a certain mystique and exoticness surrounding offshore planning that seemed inherently intimidating to creditors. Many believed Offshore Asset Protection Trusts (OAPTs) were the holy grail of asset protection and that the assets placed in these trusts would always and forever be safe from creditors in all circumstances. The typical plan was for the offshore trustee to refuse to make any payments to the beneficiary while he was experiencing an "event of duress" i.e. creditor attack. Since the trustee and assets were outside of the U.S., a U.S. judge did not have the power to reach the assets.

Unfortunately, as we discussed earlier in this book (such as in our chapter on asset protection trusts), the OAPT was not as impervious as everyone thought, and beginning in 1998 a handful of OAPTs failed. Essentially, although OAPT assets were outside a U.S. judge's reach, the OAPT's beneficiaries were not, and in more than one instance the judge did not believe the debtor-beneficiaries were incapable of repatriating trust assets. The judge subsequently issued a repatriation order and when the debtors (due to actual inability or otherwise) failed to comply, they were incarcerated for civil contempt.[375] One such unfortunate soul, Stephan Lawrence, was not released for seven years. To this day his wealth remains safely offshore, but he certainly paid a heavy price for such protection!

Despite the failures of the OAPT, to this day some planners still sell them as a one-size-fits-all solution. Others continue to use OAPTs as their primary asset protection tool, however they caution that an OAPT should not be set up after creditor threats have already arisen, since doing so would likely be deemed a fraudulent transfer. But the truth is that if a judge believes a debtor has the power to repatriate OAPT assets, the law allows a judge to issue the order even if there are no fraudulent transfer issues. This is because the laws of all 50 states[376] do not allow an offshore self-settled trust (where the trust's grantor is also a trust beneficiary) to protect one's assets from creditors. For example, Texas Trust Code, §112.035(d) says:

> "If the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of his beneficial interest does not prevent his creditors from satisfying claims from his interest in the trust estate."

Notice that there is no time limit to restrict the effectiveness of this statute (neither is there a time limit in the corresponding statute of other states' laws). This means that, by law, a creditor can reach the assets of a self-settled trust regardless of when the assets were transferred to the trust, whether the transfer is the day before a judgment or 50 years beforehand. Whether or not the transfer is fraudulent as to creditors, then, has nothing to do with whether or not an OAPT's assets are subject to creditors. Therefore, the only line of defense an OAPT has against creditors is that the trust's beneficiary supposedly does not have the power to repatriate trust assets. Unfortunately, case law places the burden of proving an inability to repatriate trust assets with the debtor[377] — and if a debtor who is subject to a repatriation order cannot prove such inability, he is probably going to jail for a while!

The silver lining to the OAPT cloud is we now have a much better idea as to what types of offshore planning works, what doesn't, and why. Furthermore, there are in fact two protective advantages an OAPT offers that a domestic structure does not:

1) OAPTs continue to be very intimidating to the unsophisticated creditor, and as a result most OAPTs are never challenged, even if the trust's beneficiary comes under creditor attack. Most creditors simply don't know how to go about undoing this type of "exotic" structure. This is why, among the thousands of offshore trusts in existence, only a few have failed.
2) If a trust beneficiary is able to prove he is unable to repatriate offshore assets, then the structure works. Such is the case with *U.S. v. Grant*, which we discuss in more detail later in this chapter.[378] Even though it appeared their trust had initially failed, since the trust allowed Arline Grant to replace the Trustee at any time (thus subjecting her to a U.S.

> court order to replace the offshore trustee with a court-appointed receiver), the trustees refused to obey the court order, and the court ruled that Arline had done everything in her power to obey the court order. Subsequently, she was not held in contempt for failure to repatriate trust assets, and at least in this case the OAPT worked. The chapter in this book entitled "Asset Protection a Judge Will Respect" discusses in detail the case law regarding repatriation orders.

For the best asset protection planners, the OAPTs that have failed have been valuable lessons as to how to do offshore planning properly. The most important lesson we've learned is this:

> **even though assets may be outside a judge's jurisdiction, as long as our clients remain in the U.S. we must plan so that our client's assets will remain safe even if the plan were entirely domestic.**

Of course the foregoing leads us to ask the inevitable question: why go offshore if your offshore planning is done as if (for asset protection purposes) the plan were domestic? The fact of the matter is offshore planning *does* offer two additional layers of protection that a domestic plan does not: the intimidation factor and an inability to repatriate the asset. However, the experienced planner knows that these extra layers of protection are on rare occasion insufficient. Therefore, we add as many layers of protection to our plan as possible, which means we incorporate the protections found in domestic planning to our offshore plan. This could include, among other things, the charging order protection common to LLCs and LPs (which is why we often use offshore LLCs in lieu of an OAPT), or exemption planning, or the §8(a) transferee defense found in the UFTA (fraudulent transfer law), or any other number of available strategies. Furthermore, the best planners realize that going offshore for the sake of going offshore is an inherently suspicious action in the eyes of a judge. Therefore, we need to have a valid reason for going offshore other than asset protection. The best reasons for going offshore are discussed in the immediately preceding chapter as well as the chapter entitled "Asset Protection a Judge Will Respect."

Now that we understand the underlying theme that should be present in all offshore plans, we can now discuss the mechanics of actually setting up a solid offshore platform.

Proper Structuring of Offshore Management

Of all the considerations that must be made when formulating an asset protection program, one of the most overlooked and critical factors (aside from fraudulent transfer concerns) is management structure. Although a properly structured onshore management entity can certainly enhance any asset protection program, using an offshore company offers some unique benefits that cannot be achieved any other way.

There are two threats to a manager that can be avoided by using an offshore management entity. The first threat is that, if litigation arises, a company or trust's manager/trustee can be added as a co-defendant of the lawsuit, if the plaintiff's attorney alleges that the manager acted in bad faith or is guilty of gross negligence. This is a very common tactic used by attorneys, and can be an effective means of placing extra pressure on a defendant in order to negotiate a settlement favorable to the creditor, even if the claim of bad faith or negligence has no merit. The threat of managers being placed in harm's way is why insurance companies have director's insurance policies for upper-level management. Placing a management company and its managers outside a U.S. court's jurisdiction makes it extremely difficult for a creditor to pursue this avenue of attack.

The second threat is that if the manager is or can be placed within the jurisdiction of a U.S. judge, the judge may order the manager to do something that would compromise a debtor's asset protection program. For example, a judge could order the manager of an LLC to make distributions of company assets, so that a creditor who is assigned a charging order interest may collect what would normally go to a member-debtor. Even though the court's repatriation attempts were ultimately frustrated, this is more or less what happened in the case *U.S. v. Grant*,[379] which focuses on whether Arline Grant has the ability to replace the manager (trustee) of her offshore trust. In the Grant case, Mr. and Mrs. Grant had formed two offshore trusts in 1983 and 1984. They subsequently encountered tax difficulties which culminated in a final judgment in March 2003, resulting in a tax lien for $36 million. With the death of Raymond in January 2005, Arline was left as the sole living grantor and beneficiary of the trusts. She was ordered to repatriate trust assets, and she claimed she was unable to do so. However, she had retained the power to appoint a new trustee. The court states:

> "…the query must be: …does the beneficiary retain such control that she has the power vested in her in some way by the terms of the trust to repatriate the corpus? …if the Defendant here has the power to change trustees or to repatriate assets, she cannot avoid the obligation by saying, "I choose not to do so," without incurring the dire consequence of such an avowed choice …the Bermuda Trust document states that:
>
> 'During the lifetime of the Grantor, he (or, following his death, his said spouse, ARLINE GRANT, if she shall survive him) shall have the right, at any time, to discharge an existing or acting Trustee (including the Trustee executing this Agreement) and to appoint such other Trustee in any jurisdiction throughout the world, as he (or his said surviving spouse) may in his (or her) sole and unreviewable discretion determine.'
>
> ...Clearly, she has such power. She has unreviewable discretion to change the trustees, and the present trustees must comply with such a request. This Court can, therefore, order Ms. Grant to change the trustee of

each trust to a U.S. trustee, which will result in the repatriation of these assets."

As we can see from the Grant case, if a judge is able to order a defendant to place management within a judge's jurisdiction, even the most advanced plan may fall apart. Fortunately for Ms. Grant, her offshore trust's trustees refused to cave in to U.S. courts, and the court decided Ms. Grant had done all she could to repatriate trust assets and therefore would not be guilty of civil contempt; unfortunately other OAPTs have not fared as well. There are domestic liability shields, such as charging order protection, that can be very formidable *if* alter-ego and fraudulent transfer concerns are not an issue, *but* if those concerns are an issue, then an offshore program with proper management structure may be your only solid firewall against an aggressive and sophisticated creditor.

When using an offshore management structure, the authors specifically recommend the Nevis LLC as a management company. Among other things, the Nevis Limited Liability Company Act is based upon the corresponding Delaware Act. Therefore, Nevis law integrates very well with U.S. law, which means its laws will be more familiar to a U.S. judge, and thus we can predict with much greater accuracy how a U.S. judge would interpret Nevis LLC law as opposed to the law governing some bizarre offshore hybrid entity that would be completely alien to him. Furthermore, although some may think that using an offshore LLC would make management more difficult, this is not true. Although many offshore entities face complex and sometimes very punishing international tax laws (for example, an offshore partnership subject to U.S. taxation must withhold 30% of its U.S.-source income and turn it over to the U.S. government[380]), an offshore LLC may elect to be taxed as an entity disregarded from its owner.[381] This means that its taxable activity is treated as that of its owner, and reported on the owner's tax return. Furthermore, even though the LLC is domiciled offshore, this LLC in turn may be managed by an onshore individual while the creditor seas are calm, as long as there is also an offshore manager and the operating agreement forbids the distribution of assets without both managers' consent. At the very first sign of creditor threat, the Nevis LLC's onshore manager should be fired or resign so that there is only an offshore manager. As long as the LLC's operating agreement is drafted correctly (which is absolutely critical!), all managing parties will now be outside of U.S. jurisdiction and thus not subject to a U.S. court order.

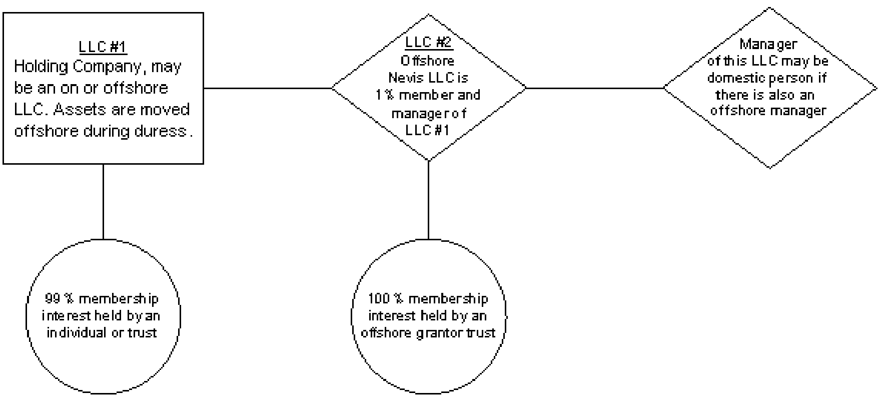
Using an Offshore Trust to Hold Offshore LLC Membership Interests

Although management is now wholly located outside U.S. jurisdiction, a clever creditor may convince a judge to order the onshore members of an offshore LLC to vote out the offshore manager and replace him with an onshore manager, who would be subject to the court. We can counter this problem by having the LLC's membership interest wholly owned by an irrevocable offshore grantor trust. If the trustee has discretionary power to vote as the LLC's member and is also located offshore, then he would not be required to obey a U.S. judge's order, thus preventing replacement of the manager.

In light of the Anderson case[383] and other landmark court decisions regarding offshore trusts, the authors feel that an offshore trust should not be structured in a manner that might be frowned upon by a U.S. judge. In other words, it is preferable that the trust not be self-settled.[384] An ideal offshore trust could be, for example, a trust with the grantor's children as the beneficiaries. Because the offshore trust need have no more than a 1% interest in the offshore LLC it manages, its member distributions would be minimal. These distributions could be reduced even further if the onshore manager charged the offshore LLC a management fee for his services.

Figure 17.1 below illustrates a scenario that would meet the criteria of the structure we've discussed.

FIGURE 17.1



Critical Considerations When Drafting an Offshore LLC's Operating Agreement

There is much more to drafting an effective operating agreement than can be discussed in this chapter. However, there are several considerations that are critical when drafting operating agreements for both the onshore company and its offshore management company.

- The onshore company should not give any member the right to a return of capital, unless the management and all members unanimously agree.
- Companies of perpetual duration are preferable to those with a specified termination date.
- The offshore managing LLC should be the sole and exclusive manager until replaced.
  - o It should not be replaceable unless all members unanimously consent.
  - o It should have at least 1% membership interest in the onshore entity, so that it also has to consent in order to effect its replacement.
- If desired, the offshore managing LLC's operating agreement should provide for a protector, and the protector should be authorized and required to replace any manager who becomes the target of a lawsuit or other creditor attack. The protector should then replace the manager with a manager located offshore.
- The offshore LLC's operating agreement should stipulate that its manager be paid a fee, unless you have an offshore individual who would be willing to manage the entity for free under times of duress. Even then, the operating agreement should at least allow for a management fee.
- If the offshore LLC has a grantor trust as a member, make sure the trust document is irrevocable, and also gives the trustee the power to vote as an LLC member.
- Operating agreements of onshore and offshore LLCs should both allow for member distributions to be withheld, in the manager's sole discretion, and converted to operating capital for the betterment of the company.
- Operating agreements of both LLCs should reinforce the charging order protection found in statutory law, and stipulate that it is the exclusive remedy of a member-debtor's creditor. Assignment of LLC interests should be likewise addressed.
- It is always a good idea for an operating agreement to have a buy-sell provision.
- The operating agreement could also stipulate that no member, manager, or other person or entity may have the right to disclose the contents of the operating agreement to a non-member or non-manager without unanimous consent of the members and the managers. In some states, such as Florida, this provision will actually be honored by a judge.

- o Note however that it is not always a good idea to keep the operating agreement private. Sometimes the operating agreement may need to be examined by a court in order to save your skin. It is nice to have this option if you need it though!
- o Placing the operating agreement in the hands of an offshore manager will give another layer of protection if you wish to keep it from falling into the wrong hands. Keep in mind that most states require the operating agreement and other company documents to be kept at the LLC's principal place of business. However, most states allow this place of business to be located anywhere in the world.

In light of our discussion thus far, what can use what we know about offshore planning in an asset protection context to judge the relative efficacy of a particular offshore structure. In Table 17.1, we examine the various components of each structure. We also rate, on a scale of 1 to 10, the expense associated with implementing and maintaining each structure. As you can see, the most expensive structures are not always the best. For a client wishing for maximum asset protection and estate planning benefits, we recommend the Offshore Ultimate LLC, which is an offshore LLC owned by a domestic Defective Beneficiary Taxed Trust (DBETT) — compare its many advantages to the far inferior yet similarly priced OAPT! For those looking for a simpler, more "bang for your buck" solution, we would recommend an offshore multi-member LLC or an offshore DEMMLLC. We will note however, that on occasion an offshore non-self settled trust would be most appropriate, and in rare occasions (for example, if the trust's grantor was a non-U.S. person) even a standalone OAPT is ideal; each structure does have its own unique idiosyncrasies that on rare occasion make it preferable to a structure that would in most circumstances be far superior. The best offshore planners thus understand when an exception to the rule applies to a particular situation, and will tailor their client's plan accordingly.

Table 17.1: Comparison of Various Offshore Structures

Entity Type	Subject to Withholding Tax?	Charging Order Protection?	Spendthrift Protection?	Subject to Repatriation Order?	Costs and Complexity (1-10 Scale, 1 is Simplest)	May Benefit Self?	Can Possibly Reduce Estate Taxes?	Inherently Reinforced Against Fraud't. Transfer Ruling?
Offshore SMLLC	No	Maybe	No	Only if a fraud't. transfer w/no §8(a) defense or no charging order protection	2 to set up, 3 to maintain (1 to maintain if no offshore manager)	Yes	No	Yes
Offshore DEMMLLC	No	Yes	No	Only if a fraud't. transfer w/no §8(a) defense	6 to set up, 4 to maintain (5 if a member is offshore trust)	Yes	No	Yes
Offshore LLC Taxed as Partnership	Possibly	Yes	No	Only if a fraud't. transfer w/no §8(a) defense	4 to set up (5 if set up w/attempt to circumvent withholding req.), 7 to maintain (8 if subject to withholding)	Yes	Yes, possible 10-50% valuation discount	Yes
Offshore ULLC	No	Yes (2nd line of defense)	Yes (1st Line of Defense)	Only if a fraud't. transfer w/no §8(a) defense.	8 to set up, 4 to maintain	Yes	Yes, up to 100% estate tax free	Yes
IBC	Possibly	No	No	Yes, if IBC stock is seized by creditor (very likely!) or if a fraud't. transfer w/no §8(a) defense	4 to set up (5 if set up w/attempt to circumvent withholding req.), 7 to maintain (8 if subject to withholding)	Yes	Yes, possible 10-50% valuation discount	Yes
OAPT (Self-Settled)	No	No	No	Yes, unless debtor proves inability to repatriate	8 to setup, 7 to maintain	Yes	No	No
Offshore Trust, Non Self-Settled	No	No	Yes	Only if a fraud't. transfer w/no §8(a) defense	8 to setup, 7 to maintain	No	Yes, "estate freeze" possible	No
Offshore Foundation	Typically no (so long as its tax-exempt or taxed like a grantor trust)	No	Yes, if used for bona-fide charity	Only if a fraud't. transfer w/no §8(a) defense	8 to *properly* setup, 8 to maintain	No	Yes, but only by giving assets away to charity	No

CHAPTER EIGHTEEN

Asset Protection a Judge Will Respect

Asset protection plans are put to the ultimate test when scrutinized in court. Knowing how to structure a plan to survive such scrutiny is what separates a great planner from the mediocre masses. Fortunately, the courts themselves have told us what types of planning will and won't be respected.

Having a Legitimate Purpose for Your Plan

In one case, a court gives clear instruction on what kinds of asset protection planning are or are not acceptable when it says:

> " 'Asset protection' is not illegal and is honored by the law if done for a legitimate purpose. For example, an individual may do business through a corporation or limited liability company and will not be held personally liable for the debts of the entity. The assets of the corporation or limited liability company will not be considered the assets of the individual interest holder. However, an entity or series of entities may not be created with no business purpose and personal assets transferred to them with no relationship to any business purpose, simply as a means of shielding them from creditors. Under such circumstances, the law views the entity as the alter ego of the individual debtor and will disregard it to prevent injustice."[385]

It is of further note that this case mentions the defendants' meeting with and use of an asset protection planner as evidence that the plan was implemented to thwart creditors. The asset protection planner was even subpoenaed and forced to testify! Subsequently, the defendant's structure was deemed a sham, and the defendants lost their wealth. (This could have been avoided if the planner had worked under an attorney, which we'll discuss shortly.)

There are some situations where estate or tax planning, instead of a business purpose, is a legitimate alternative reason for using certain entities. This is especially true of non-self-settled trusts, which are often statutorily protected from creditors if they contain a spendthrift clause.[386] However, using business entities (such as family limited partnerships) solely for estate or tax planning, with no business purpose behind it, can be a recipe for disaster. This was the case with *Strangi v. CIR*, wherein a family limited partnership was pierced because it had no business purpose and had not invested its assets in any form of business venture.[387]

The above cases lead us to deduce the following:

1) It's better for an asset protection planner to work under an attorney rather than work for a client directly (although initial contact with a planner should not give cause for concern). This insures that the program will be protected by attorney/client privilege and privileged work product, which will preclude the planner from being forced to give testimony that may very well undo your program.
2) Business entities, such as LLCs, corporations, and limited partnerships, should always have a bona fide, demonstrable business purpose.[388] If the business entity holds investments, then it is best to trade or exchange more than just a *de minimis* amount of its investments from time to time to demonstrate that the entity is actively engaging in business rather than merely holding assets.

In addition to the foregoing, there is a simple and effective litmus test for determining whether an asset protection program is likely to pass court scrutiny. Simply ask yourself: "if a judge asked me why I set up my affairs the way I did, what will I say?" (We put this litmus test in bold print because it is very important! It should be used when structuring ANY asset protection program that does not have a built-in business purpose.) If the only answer you can think of is "I set up my financial affairs so as to avoid creditors" then you have a program that will likely fall apart when challenged. This is not only true when a program is set up after a lawsuit arises; it may also be true even if the plan is set up while creditor seas are calm. The case *U.S. v. Townley* validates this fact.[389] In this case, Mr. and Mrs. Townley had transferred their home into a non-self-settled trust years before they ran afoul of the IRS. However, Mr. Townley's own testimony as to the reason for the trust proved to be his undoing. The court notes:

> "…a transfer of property made with actual intent to delay, hinder, or defraud a creditor is prohibited… Mr. Townley stated in his deposition that he was concerned about potential 'lawsuits from the exposure we had from liability from troubled boys in the State of Washington.' (Ct. Rec. 58, Ex. 1). Additionally, Mr. Townley stated that it was his goal to protect his assets from anyone who might get a judgment against him… Plaintiff asserts that *Mr. Townley's statements that he intended to protect his assets from anyone who might get a judgment against him is conclusive, direct evidence of intent to hinder, delay, or defraud. The Court agrees.*" [emphasis is ours]

Some people might think structuring a program with a bona fide business purpose would require an excessive time and effort commitment. For the most part, this is simply not so. For example, a home can be equity stripped via an LLC capitalization tactic (discussed in Chapter 15) where the LLC trades stocks and bonds; this program, although slightly more effort intensive, has a built-in business purpose and will save a client thousands of dollars in interest payments over using a debt-based equity stripping program. Cash can be placed in an LLC and then invested into stocks, bonds, real estate, or other assets that are likely to appreciate and generate profit. Retirement funds may be rolled over to a self-directed IRA that invests in an offshore LLC, which in turn either operates as a business or actively engages in investment activity. Life insurance policies could be placed in an Irrevocable Life Insurance Trust (ILIT), which need have no business purpose. The list goes on and on. These are things many financially savvy individuals would do anyway, regardless of whether they were trying to protect assets. Of course a skilled planner needs to be knowledgeable about a wide variety of business entities and trusts, so as to be able to creatively and skillfully use these entities in a manner that will appear legitimate when scrutinized in court.

If desired, the above entities can be structured so as to be disregarded for tax purposes. This minimizes or even eliminates the requirement to file informational tax returns. Instead, incomes from the entities are often simply reported on the owner's or grantor's 1040 Schedule C return.[390]

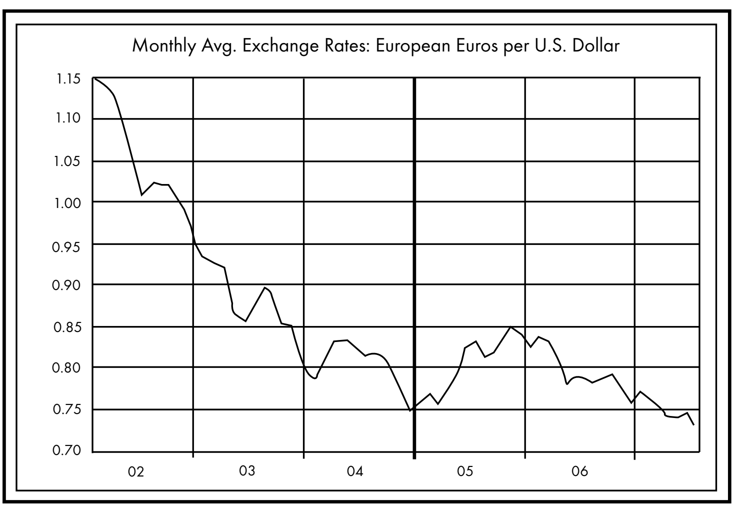
The Plummeting Dollar, Offshore Insurance Products and Other Economic Reasons for Going Offshore

But what about going offshore? Even if your offshore program has a valid business purpose, a judge may well ask "why couldn't you have just done that onshore?"[391] We need to have a plausible response. Fortunately, the trend of a weakening U.S. dollar provides us with an answer. For example, between January 2002 and January 2005, the dollar weakened against the Euro an astounding 56% (Figure 18.1 illustrates this data.) Furthermore, the MSCI EAFE index (an index of stock market performance among a broad segment of global markets) outperformed the

S&P 500 by an average of 60% over the last 6 years (see figure 18.2). Imagine how much better off you would have been financially had you invested in an offshore insurance product (such as a tax-deferred variable universal annuity (VUA), tax-advantaged variable universal life (VUL) policy, or portfolio bond) earning 8-12% annually, especially if that annuity had been based on the Euro! Personally, we think it's essential for anyone of significant wealth to invest a portion of their liquid assets in an offshore insurance product based on a stable, nearly debt-free currency such as the Euro or Swiss Franc (note that the Swiss Franc has the additional stabilizing benefit of being gold-backed, which is a chief reason why it is historically the world's most stable currency). And although an offshore entity is not needed to merely buy these currencies, you *must* have an offshore entity if you want to purchase an offshore annuity or other structured financial product in order to receive a guaranteed additional return on your investment. Therefore, going offshore may give you a bona fide economic benefit you wouldn't be able to achieve any other way.

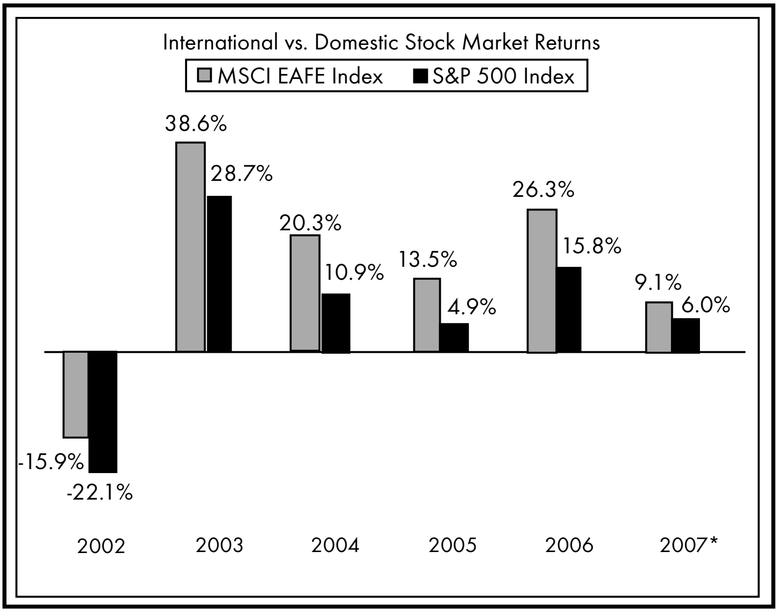
In light of the above, do you think a judge would agree that it sometimes makes economic sense to go offshore, in order to gain a benefit you couldn't obtain otherwise? Of course, and that's what we need to get a judge to respect your program.

FIGURE 18.1



The above graph © 2007 by Prof. Werner Antweiler, University of British Columbia, Vancouver BC, Canada. Permission is granted to reproduce the above image provided that the source and copyright are acknowledged. Time period shown in diagram: 1/Feb/2002 - 15/Jul/2007

FIGURE 18.2



Avoiding Repatriation and Civil Contempt Nightmares

The primary advantage of offshore planning is the location and control of assets is outside the jurisdictional reach of a U.S. judge. Even if a transfer offshore is determined to be fraudulent, the judge may not have the ability to aid a creditor in retrieving those assets. However, case law has shown that if a judge believes a debtor has the power to repatriate offshore assets, notwithstanding their claims to the contrary, he will issue a repatriation order. Failure to comply with this order can (and has) landed more than one debtor in jail.[392] Furthermore, if a debtor transfers assets offshore after creditor threat has arisen, in an egregious manner, then his 'self-created impossibility' of being unable to repatriate assets may not be believed by a judge. In other words, the debtor has placed himself in a position where he doesn't have the power to repatriate assets, but a judge doesn't believe his claim of powerlessness, and therefore he has no choice but to spend time in jail due to civil contempt of court![393]

A few planners have cited examples of these occurrences to mean that offshore planning will, when challenged in court, always subject one to a repatriation order and threat of civil contempt consequences for failure to comply. Case law, however, demonstrates this is simply not so. Even when assuming the offshore transfer is fraudulent, or that the plan otherwise fails, the U.S. Supreme Court notes that a finding of contempt for failing to obey a repatriation order is not always appropriate:

> "In a civil contempt proceeding such as this, of course, a defendant may assert a present inability to comply with the order in question. Maggio v. Zeitz, supra, at 75-76; Oriel v. Russell, 278 U.S. 358, 366 (1929). While the court is bound by the enforcement order, it will not be blind to evidence that compliance is now factually impossible. Where compliance is impossible, neither the moving party nor the court has any reason to proceed with the civil contempt action. *It is settled, however, that in raising this defense, the defendant has a burden of production.*"[394] [Emphasis is ours.]

An analysis of relevant cases (such as the infamous "Anderson" case[395]) in conjunction with the above excerpt shows that debtors who were held in contempt were not incarcerated for failing to repatriate assets; rather, their critical blunder was failing to prove their inability to repatriate assets. It is perhaps most important to note that debtors who were subsequently held in contempt, without exception, took extraordinary measures to effect a 'self-created impossibility' to repatriate assets, which did nothing but invoke the suspicion and wrath of a judge whose orders were being flaunted.[396] On the other hand, the case *U.S. v. Grant*[397] demonstrates that, when a debtor does their very best to repatriate assets, yet is unable to do so, a court may indeed not hold that person in contempt of court for failing to reply with the order. In Arline's case, her OAPT worked, and she stayed out of jail because, in the judge's opinion, she met the burden of proof necessary to demonstrate her inability to comply. This involved her sending written requests to both the offshore trustee, as well as all the financial institutions holding trust assets, to comply with the court's repatriation order. The trustee and financial institutions all replied that they were unable to comply with the order since to do so would violate the trust agreement. The authors feel that, in this case, and in light of all other OAPT case law, Ms. Grant did have luck on her side in this instance, which is why we never recommend an OAPT as the only line of defense against a repatriation order. Nonetheless, the *Grant* decision demonstrates that, when done properly, the "impossibility defense" can work to protect assets against creditors, even if that creditor happens to be (as was the case in *Grant*) the federal government.

There are many things that can be done to avoid the repatriation/contempt problem. For example, most U.S.-situs courts are biased against offshore asset protection trusts, since 42 states currently don't allow self-settled trusts of any kind to provide asset protection. However, an offshore LLC, like a domestic LLC, benefits from charging order protection as long as it is used for a valid business purpose, and is thus a much more acceptable entity in the eyes of a judge. If the

LLC then invests cash into an annuity or other policy that's administered by a large, well-respected offshore insurance company, before creditor threat arises, then a production of the policy contract provides ample evidence that the LLC's owner is unable to repatriate those assets (and, unlike offshore trusts, we have a reason for the policy besides asset protection!) An operating agreement can also appoint an offshore manager, or at least forbid the LLC members from distributing offshore assets without the approval of an offshore individual (the LLC members who are U.S.-based would ideally never be signers on any offshore accounts, and language should be placed in the operating agreement that shows one of the LLC's purposes is to build capital within the company. In other words, the LLC's operating agreement makes it clear from the start that distributions are to be limited.)

Even if additional contributions to the offshore structure are made after creditor threat arises (thus placing more assets offshore), these transfers are likely to be seen as acceptable if a program has been implemented and funded in advance of creditor threat, and the subsequent transfers have a demonstrable economic benefit. Furthermore, offshore asset protection is not the first line of defense for most of our assets. Most assets will be held in domestic entities before creditor threat arises. Therefore any assets placed offshore after creditor threat arises were not the debtor's in the first place (and thus wouldn't be subject to creditor attachment unless the domestic entities were pierced); the offshore component is just another layer of protection reinforcing a plan.

To summarize, instead of being obvious about what we're doing, we are subtle. We use camouflage. We have a bona fide reason for doing what we're doing besides asset protection. We do things so as to be able to prove our inability to repatriate assets if needed. We have liability insurance that will pay a reasonable amount of the claim, thus ensuring that the plaintiff's attorney gets an easy payout, which serves to divert him from the tough and uncertain uphill battle he'll have to wage if he wants any significant portion of the debtor's personal wealth. We appear to be conducting 'business as usual'. In fact, we really are doing 'business as usual', which is why our program stands up in court.

Asset Protection Will Likely Not Protect Your Wealth if You're a Scam Artist, Con-Man or Otherwise Disreputable Person

It is no coincidence that many of the more infamous cases (the Anderson case, In re: Lawrence, et al) where asset protection failed were cases that involved financial fraud, bankruptcy fraud,[398] or other criminal acts. Indeed, using a limited liability entity to shield one or their wealth from the effects of fraud falls squarely within the "improper use" doctrine,[399] which is one of the fundamental arguments used to pierce the veil of limited liability entities. Committing fraud does not *ipso facto* mean a perpetrator's plan will fail, since a judge must consider how innocent parties may be affected by the veil-piercing or reverse veil-piercing of an entity (for example, if a person commits fraud and his wealth is in a multi-member LLC, and that LLC has creditors arising from its normal business activities, the judge must consider whether the LLC's creditors and other members would be unfairly harmed if the judge allowed a portion of LLC assets via reverse-piercing to be given to a creditor of the debtor who committed fraud.) However, if you're a con-artist, fraudster, evader of child support payments, one who commits perjury or plays other such evasive games with the court, etc., you will almost certainly find your asset protection plan at a great disadvantage before the court as compared to an identical plan implemented by someone who is more or less a law-abiding citizen.

This truism is especially relevant in relation to offshore assets subject to a repatriation order. Even if you meet the burden of proof that you are unable to repatriate offshore assets, remember it is the judge who decides whether or not you've actually met that burden. If the judge believes you've committed a crime or other disreputable act, he may set the bar so high (in regards to proving your inability to repatriate assets) that you may not be able to meet it, even if you are in fact unable to repatriate those assets.

Structuring an Entity a Judge Will Respect: the Devil is in the Details

The intent and purpose for forming an entity is not all we must pay attention to. The legal structure of an entity must also be carefully planned if it's to hold up in court.

As discussed in Chapter 10, an analysis of the case *In re: Ashley Albright*[400] shows us single member LLCs are sometimes susceptible to losing their charging order protection. However, although rare, even multi-member LLCs sometimes find their charging order protection compromised. Fortunately, multi-member LLCs can be reinforced against this threat through the utilization of a strategy created by the authors, known as Entanglement Theory.

Before discussing Entanglement Theory, we must examine the circumstances in which a multi-member LLC's charging order protection fails. Besides *In re: Ashley Albright*,[401] three other cases are relevant to this topic. The first two, *Crocker National Bank v. Perroton*,[402] and *Hellman v. Anderson*,[403] come from California district courts. In both cases, the court decides to ignore a limited partnership's charging order protection because, the court ruled, charging order protection was originally enacted as a means of protecting the non-debtor partners, and to insure that partnership business is not interrupted, not so that a debtor partner can escape paying his debts. In both cases the partnership interest could be transferred to the creditor without causing an interruption in partnership business. As a result, the courts on both occasions decided that charging order protection did not apply, and the partnership interest was transferred to the creditor. Although the court only allowed this transfer with the other partners' consent in the Crocker case, in Hellman the court allowed the transfer without the consent of the non-debtor partners. Although these cases currently only apply in California, they set a precedent that may be imitated in other courts nationwide.

Another situation in which charging order protection may fail is found in a recent bankruptcy proceeding, *In re: Ehmann*.[405] The court ruled in *Ehmann* that the debtor's LLC membership interest in Fiesta Investments, LLC was forfeit to the bankruptcy estate due to the fact that the LLC's operating agreement was not an executory contract. Under bankruptcy law, an executory contract would include an agreement wherein the member and the LLC have reciprocal obligations. Such an executory contract would be subject to §§ 365(c) and (e) of the Bankruptcy Code (Title 11 U.S.C.), which would uphold the limitations of state or other applicable law. The court makes it clear however, that §§ 365 (c) and (e) do not apply to non-executory contracts when it states:

> "The Court here concludes that because the operating agreement of a limited liability company imposes no obligations on its members, it is not an executory contract. Consequently when a member who is not the manager files a Chapter 7 case… the limitations of §§ 365(c) and (e) do not apply."

If an operating agreement is non-executory, the LLC interest would instead be subject to Title 11 U.S.C. §§ 541(a) and (c)(1). As the court noted:

> "Code § 541(c)(1) expressly provides that an interest of the debtor becomes property of the estate notwithstanding any agreement or applicable law that would otherwise restrict or condition transfer of such interest by the debtor. All of the limitations in the Operating Agreement, and all of the provisions of Arizona law on which Fiesta [Investments LLC] relies, constitute conditions and restrictions upon the member's transfer of his interest. Code § 541(c)(1) renders those restrictions inapplicable. *This necessarily implies the Trustee has all of the rights and powers with respect to Fiesta that the Debtor held as of the commencement of the case.*" [Emphasis is mine.]

Although there was plenty in Fiesta Investments, LLC's operating agreement that obligated the LLC and its manager to the debtor, there was nothing that obligated the debtor to perform any service or make any contribution to the LLC. Therefore, the operating agreement was non-executory, and the debtor's membership interest was forfeit, statutory charging order protection notwithstanding.

In light of the above cases, there is yet another situation wherein charging order protection may be circumvented. That is where all members of the LLC are debtors to the same creditor. In this situation, the underlying reasons for charging order protection would not apply to the fact pattern, and therefore a court could conceivably disregard charging order restrictions.

To summarize, we can see that the following factors may jeopardize the charging order component of an asset protection plan:

1) The LLC is a single member LLC - this is especially dangerous.
2) The LLC's operating agreement is non-executory in nature (however this is currently only a problem in bankruptcy.)
3) The forfeiture of a debtor's membership interest to a creditor would not interrupt partnership business.
4) All members of the LLC become a debtor of the same creditor.

It is obvious that if we wish to structure an LLC or LP[406] for maximum asset protection, we must effectively counter the above pitfalls. These pitfalls are sidestepped with the utilization of Entanglement Theory. Entanglement Theory is the process of "entangling" the relationships of various LLC members with the LLC and each other (in connection with their obligations and rights to benefit from LLC membership) so that if a particular member of the LLC was taken out of the picture, then the business of the LLC, and the interests of the other members, would be significantly impaired. We are fortunate to have case law that confirms the efficacy of this strategy, since the courts generally forbid a 'reverse-piercing'[407] of an entity (even a non-charging order protected entity, such as a corporation) if innocent company owners or creditors of the company would be harmed. In one case, for example, we read the following:

> "We recognize … that there are other equities to be considered in the reverse piercing situation – namely, whether the rights of innocent shareholders or creditors are harmed by the pierce."[408]
>
> Another case echoes this sentiment in greater detail:
>
> "In addition, the reverse-pierce theory presents many problems. … third parties may be unfairly prejudiced if the corporation's assets can be attached directly. Although … our particular concern was with non-culpable third-party shareholders of the corporation being unfairly prejudiced, no greater culpability should attach to the third-party corporate creditors harmed by reverse-piercing in this case. See id. ("… the doctrine cannot be applied to prejudice the rights of an innocent third party.") (quoting 1 William Meade Fletcher et al., Fletcher Cyclopedia of the Law of Private Corporations § 41.20, at 413 (1988 Supp.)) …; see also Hamilton v. Hamilton Properties Corp., 186

> B.R. 991, 1000 (Bankr. D. Col. 1995) ("The reverse piercing theory is an aberration which, if invoked, would prejudice . . . the rightful creditors of the corporation whose assets are subsumed for the benefit of the creditors of the individual. What of the creditors of [the corporation] who relied on its separate corporate existence in doing business with it?"); Cargill, Inc. v. Hedge, 375 N.W.2d 477, 479 (Minn. 1985) (holding that in considering propriety of reverse pierce, "also important is whether others, such as a creditor or other shareholders, would be harmed by a pierce").

Obviously, if there is only one member in an LLC, there is no one else to become entangled with (especially if there are no LLC creditors), so the first thing we must do is make an LLC multi-member. There is no real obstacle to doing this with what would otherwise be a single member LLC, since a grantor trust can easily be added as a 2nd member, thus preserving its disregarded entity status if such is desired for tax reasons.[410]

The next thing we must do is ensure that the LLC operating agreement is executory. It goes without saying that there are many considerations that must be made when drafting an operating agreement, in order to ensure that the highest possible degree of asset protection is obtained. Such considerations are without the scope of this article, yet we'll explore a few ideas for making such an agreement executory. *In re: Ehmann* shows us that an LLC agreement is executory when the members have the following obligations:

1) Ongoing obligations to contribute cash to the entity;
2) Ongoing obligations to contribute non-managerial services to the entity;
3) Ongoing obligations to contribute equipment or other property to the entity; or
4) Ongoing obligations to manage the entity.

The easiest way to accomplish this is to require every LLC member to do one of the following:

1) A managing member should have a written agreement to act as a company manager as long as he holds a membership interest, as a condition of continued membership.
2) A non-managing member should agree to act in an advisory or consulting role to the company as long as he is a member, as a condition of continued membership. These services should be demonstrable in court. For example, he could submit an annual report to the company, giving his recommendations as to how the company could increase its profits and become more efficient. Such a report could then be

submitted to a court to prove that ongoing executory obligations are being performed.

In addition to the foregoing, the company operating agreement should stipulate that members and managers, unless incapacitated, cannot transfer their obligations while they remain members, due to the fact that their intimate involvement with company affairs uniquely qualifies them to know how to best advise or manage the company.

Lastly, we must make sure that never, under any circumstance, could all members of the LLC personally become debtors of the same creditor. This could be done one of the following ways:

1) Make sure at least one of the LLC members is never exposed to liability. This may be accomplished by making one of the members a trust, LLC or other entity that only engages in "safe" activities, or;
2) Make sure that at least one member is not an insider or affiliate of any other member under the U.F.T.A.

Obviously, this type of structuring necessitates a very high level of skill. However, when implemented correctly, Entanglement Theory poses an extremely formidable asset protection barrier that would survive many situations a lesser plan would not.

CHAPTER NINETEEN

Using Phantom Income to Lay a Tax Trap for Creditors

Although most cases are settled out of court, we must still plan for the possibility of losing a case and becoming a judgment debtor. A judgment lien may hang over a debtor's head for twenty years or more unless steps are taken to encourage a post-judgment settlement. The best type of settlement, of course, is for pennies-on-the-dollar. Therefore it behooves us to discuss strategies that would facilitate such.

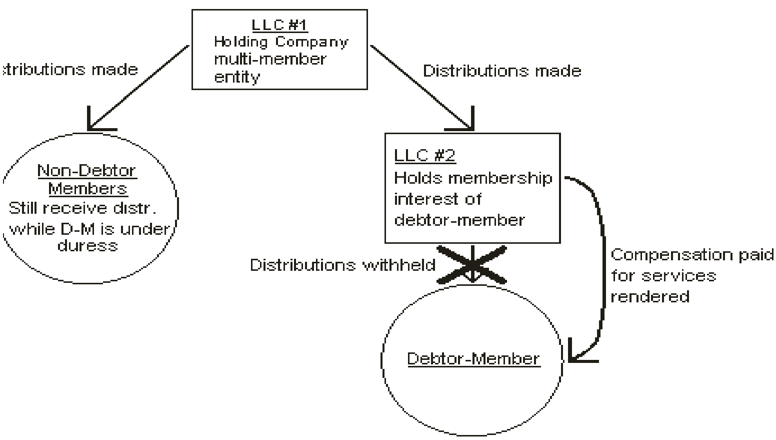
Leveraging the Charging Order to Stalemate a Creditor

The best asset protection plans often use Charging Order Protected Entities (COPEs) such as LLCs and Limited Partnerships to hold at least some assets. When a member or partner of such an entity is sued, the creditor's available debt collection remedy is restricted to a charging order. This means that he is entitled to receive only a distribution from the COPE that the debtor-member/partner would have otherwise received. However, a properly structured COPE will be able to withhold distributions within the entity (usually they are converted into operating capital) and therefore the creditor ends up with nothing. The problem then arises: how can a debtor pay for his living expenses if he is no longer receiving distributions from his entities? Fortunately, the solution is easy: he may be able to render services to the COPE as an independent contractor (not an employee, since wages may be garnished) and then be compensated by the entity. Although it is not impossible for a judgment creditor to seize such payments, a properly drafted service contract will make it very difficult. A word of caution, however: a judge would likely have a problem with a client not getting independent contractor payments pre-judgment, and then receiving such payments post-judgment. Such maneuverings could very well backfire.

The underlying strategy to this approach is to wear out the creditor. He will likely tire of waiting for distributions that never come, and eventually acquiesce a pennies-on-the-dollar settlement.

Leveraging a Charging Order in such a manner is not without its pitfalls. For example, if a COPE has multiple members, then withholding distributions from the debtor-member while making distributions to the other members would be a bad idea. Such an obvious attempt to evade a creditor would likely irritate the court and trigger unpleasant consequences. This pitfall is sidestepped by using another COPE to hold the debtor-member's company interest. Then, distributions would be made from the original entity to the debtor-member's entity, from which profits are then withheld, as is illustrated in Figure 19.1, below.

FIGURE 19.1



Using the Charging Order to Make a Creditor Settle.

Notwithstanding the effectiveness of the above strategy, a sophisticated asset protection planner would want a creditor to truly cry "uncle" instead of merely stalemating him via a fruitless waiting game. Enter IRS Revenue Ruling 77-137.

In Rev. Rul. 77-137, the IRS held that an assignee of a limited partnership interest (wherein the assignee had not become a limited partner) was liable to pay taxes on his share of gain, loss, deduction, and credit attributable to his assigned interest, if he had received dominion and control over the interest. This revenue ruling creates some interesting planning opportunities for us, along with a bit of uncertainty. First let's examine the possibilities, and then we'll examine the uncertainty.

An extrapolation of Figure 19.1 will make the planning opportunity of Rev. Rul. 77-137 apparent. In Figure 19.1, the membership interest of LLC #2 belonged to a debtor-member. Let's assume a charging order assigned the economic interest in this LLC to a judgment creditor. On April 15th of the following year, who would the tax liability for LLC #2's profits belong to? In partnership tax law, a partner is liable to pay tax on partnership gains regardless of whether those gains were distributed. In light of both Figure 19.1 and Rev. Rul. 77-137, then, it is feasible that LLC #2 could withhold distributions from the assignee and send him a tax bill (in the form of a 1065 K-1 partnership return) for the distributions he never received. In other words, if LLC #1 distributed $50,000 to LLC #2, for example, and then LLC #2 did not make any distribution, then the judgment creditor could conceivably wind up with a tax liability of $14,000 or more for money he never received! The probable outcome of such a predicament would be a quick, pennies-on-the-dollar settlement and no more problems from that creditor.

This knockout scenario is however somewhat clouded by a closer analysis of Rev. Rul. 77-137. This is because the revenue ruling states that tax liability transfers to an assignee of a limited partnership/LLC interest if the assignee has acquired all of the interest's "dominion and control". The question is: does a debtor's assignment of an LLC or LP interest mean the creditor has dominion and control over the interest? The legal community is widely divided on this issue, and since the courts have not yet provided clarification, no clear answer currently exists. Even so, an LLC or LP that has received a charging order has, at the very least, arguable grounds for issuing a K-1 return to an assignee. If the creditor-assignee doesn't like it, then he'll have to litigate in tax court. This alone may be enough to push the creditor into a debtor-favorable settlement.

Notwithstanding the uncertainty as to whether Rev. Rul. 77-137 applies to a creditor-assignee, there are two things that can happen which will ensure sure he will be liable for undistributed company profits:

- Some states allow for a foreclosure of LLC membership interests. When a creditor forecloses on his charging order, he receives the right to LLC distributions in perpetuity. Although in some ways this seems like bad news (because it means the creditor has the right to receive LLC distributions forever), a foreclosure of LLC membership interest leaves little doubt that the creditor would have complete control and dominion of the interest. Once he receives his K-1 tax bill, he will probably want to sell the foreclosed interest back to the LLC in a hurry.
- Language in an operating agreement may give an assignee sufficient dominion and control over the membership interest so as to ensure he will be the one liable for the debtor-member's taxes arising from company gain. An example of this language would be as follows:
    - *"In the event of an assignment of a limited member's interest, the Company's managers, in their sole discretion, may by unanimous agreement transfer the member's voting rights to the assignee. The transfer of a member's voting rights must be proportionate to the percentage Company membership interest assigned. A transfer of voting rights shall be effective upon delivering written notice of such transfer, signed by each manager, to the assignee and each Company member. A transfer of voting rights shall only be effective during the term of the assignment, and such rights shall revert to the assignor upon the assignment's expiration. A transfer of voting rights does not entitle the assignee to become a substitute member of the Company."*

      [Be careful! The transfer of voting rights must *not* allow a creditor-assignee to replace the company's management. Drafting an operating agreement for a multi-member LLC wherein the members may replace the manager(s) only by unanimous consent is recommended in order to avoid displacement of friendly management.]
- Perhaps the most sure-fire strategy: as part of a settlement offer, the debtor could give his (non-managing) LLC or LP interest to the creditor. This would *definitely* constitute an assignment of dominion and control over the interest, and the K-1 in tandem with withholding of distributions would almost certainly make the creditor cry uncle. This particular tactic is very useful in divorce proceedings, where the soon-to-be ex-spouse would probably want a piece of the LLC interest anyway (not suspecting that this interest is actually a trap!)

When laying any of the above traps for a judgment creditor, we must remember the importance of structuring LLC management so that the debtor-member has no control over the entity. If the debtor-member does have control over the entity, then a results-oriented judge might force him to make LLC distributions to the creditor-assignee. A multi-member LLC with a carefully drafted operating agreement and an unrelated 3rd party manager will eliminate this possibility. The most creditor-proof arrangement would involve an offshore manager that managed an offshore LLC management company.[411]

CHAPTER TWENTY

Pre-Divorce/Pre-Marital Planning

It is a widely known statistic that approximately half of all marriages in the United States fail. Nonetheless, most people see marriage as desirable. For high net-worth individuals who marry, the potential destruction of one's wealth in the event of divorce is a serious concern. Therefore, many such individuals are interested in a special type of asset protection, known as Pre-Marital/Pre-Divorce planning (PD/PM planning), as a means to minimize the hazards of a marriage gone bad.

Before we discuss PD/PM planning, we should discuss what it is not. PD/PM planning is not a means to avoid child-support payments. It will also not bar 100% of your assets from spousal attachment. Rather, PD/PM planning is a means to ensure that most of the assets you had before you married will either remain yours or revert to your ownership within 1 or 2 years of the divorce being final.

The Pre-Nuptial Agreement

The fairest and most honest way to work out the division of assets between spouses in the event of divorce is through a pre-nuptial, or sometimes post-nuptial, agreement. Many will argue that such an agreement casts a shadow on the marriage, is unromantic, and shows one's pessimism towards the possibility of a happy marriage in general. However, in the event of a divorce, a pre-nuptial agreement will reduce the emotional pain, bitterness, and cost of divorce. This is because a pre-nuptial agreement will clarify many issues that may otherwise be brutal battlegrounds in a divorce proceeding. Furthermore, a pre-nuptial agreement may clarify certain terms and expectations of the marriage itself. This helps avoid misunderstandings and misconceptions that might otherwise cause marital conflict.

Notwithstanding the usefulness of a pre-nuptial agreement, the authors have had many clients whose spouse-to-be was not willing to sign an agreement, or the client was unwilling to even approach their fiancée about an agreement. Nonetheless, the client wanted to make sure that, if the marriage ended in divorce, s/he would not lose everything that s/he had worked so hard to acquire. This is where asset protection planning and PD/PM planning coincide. The rest of this chapter will focus on asset protection strategies as applied to PD/PM planning where a pre or post-nuptial agreement is not in force.

Using Irrevocable Trusts to Insulate Assets from Divorce

If an individual places assets in a non-self-settled irrevocable trust before they marry (or, in some circumstances, after marriage), then a future spouse will not be able to attach those assets in the event of divorce. Note that there is a general rule that a self-settled trusts, which are trusts where a person is both the trust's creator and a beneficiary, will not work in this instance; we explain why this is so in chapter 12. This seems a difficult hurdle to overcome if a person wishes to place their assets in a trust and still somehow benefit from those assets. However, we can overcome this hurdle by using a Defective Beneficiary-Taxed Trust, or DBETT, which we discuss in more detail in chapter 14. The DBETT is a little-known and very advanced trust that is created by someone other than the person who wishes to protect their assets, and then that person sells their assets to the trust. The trust then pays for the assets over time by making installment payments on a promissory note it gives to the seller. The note may include language that the trust may withhold or re-direct payments if those payments would go to the seller's creditors, so as to maximize the asset protection features of the trust. The seller is also a beneficiary of the trust, and the trust is structured so that the beneficiary, rather than the trust's creator (a.k.a. "grantor") pays taxes on trust income. The DBETT works well because it is not self-settled, and thus the "spendthrift" laws of the state where the beneficiary resides provide formidable asset protection.

In some circumstances it may be possible for a DBETT to provide asset protection even if the assets are sold to it after a person marries. However, if the transfer occurs after marriage, then any asset acquired after marriage should ideally be transferred to the trust with the consent of both spouses if they reside in a non-community property state.[412] In a community property state, the consent of both spouses is absolutely necessary, since each spouse by default owns 50% of all assets acquired during marriage. Without the consent of both spouses, assets acquired during marriage that are transferred to the trust may be considered a fraudulent transfer if the trust tries to keep those assets out of the hands of the other spouse in the event of divorce. There may be an exception to this rule if the fraudulent transfer statute of limitations (usually four years;[413] seven years in California)[414] has expired, or if the transferred assets were acquired by the transferor before marriage. In any case, because of variations between state laws and the ambiguities of divorce law in general, any transfer of assets to a DBETT once a person has married should only be done after first consulting with an experienced divorce attorney.

If an individual stands to inherit assets, or wishes to give assets away to heirs or charities, then using a DBETT is not necessary. A conventional irrevocable, non-self-settled spendthrift trust will in such circumstances provide adequate asset protection from a future ex-spouse. Be sure to read this book's three chapters on trusts to fully understand what trusts are and how they can protect assets.

Using Charging Order Protected Entities (COPEs) for PD/PM Planning

In addition to the foregoing, there is one other fundamental strategy we use in PD/PM planning. This strategy involves placing assets into one or more Charging Order Protected Entities (COPEs), which are most often either LLCs, limited partnerships, or a combination of the two.[415] Then, in divorce proceedings, we offer the company interests to the ex-spouse, however in actuality this is a carefully laid trap, or Trojan Horse (we'll henceforth call this strategy the "Trojan Horse Strategy"). If divorce seems likely, management of the COPEs are shifted away from the client. Subsequently, although the ex-spouse may receive a sizeable or even near-complete ownership of the entities, he will not have any control or access to their assets. We can then either stalemate the spouse into a favorable settlement (where the ex-spouse receives a smaller share of assets than he would otherwise receive, in exchange for a return of the entities' interests that are essentially worthless to him) or, we can make sure that, although he receives *no* entity profits, he receives *all* the tax liability from profits earned by the entity.[416] Optimally, the ex-spouse will receive a sizeable tax liability from the entities, but he won't receive any funds to pay the tax. We are essentially placing the ex-spouse in a financial vice-grip. At that point, we offer to buy the company interest back, pay for the tax liability, and offer a much smaller settlement than the ex-spouse would otherwise have received.

Less Effective Pre-Divorce Strategies

Besides what we've discussed thus far, there are two other common but less effective PD/PM strategies. The most common method is for one spouse to transfer assets out of his name and hide them from the other spouse. Practically all divorce attorneys are aware of this tactic, and have subsequently found effective ways to discover hidden assets. A marginally more effective strategy is to shift assets offshore. These assets will then be outside of the divorce court's jurisdiction. While this technique can be effective, the court will usually counter this approach by giving the ex-spouse a greater portion of remaining onshore assets to compensate for the offshore assets outside court jurisdiction. Because it is usually difficult to shift all of one's assets offshore, the divorce court may be able to effectively counter this strategy.

Using the Trojan Horse Strategy is more effective than hiding assets or moving assets offshore because it allows the client to appear to be cooperating with the court in dividing marital assets. This means that neither the spouse nor the court will likely suspect any PD/PM plan is in place, and therefore the court will likely not see any reason to give more onshore assets to the ex-spouse. Indeed, if for example a client's assets are in COPEs that are not managed by him, then all he can do is give up his membership interest in the entities; that is his only choice. However, because the entities are managed by a third party,[417] both the client and court are unable to compel entity profit and/or asset distributions to the ex-spouse (even if the spouse was the manager, a court would probably not force a distribution from a multi-member LLC engaged in a legitimate business, however shifting management to another individual reinforces the LLC's asset protection features even further). Furthermore, assets may be held in domestic entities if the plan is implemented at least, at a bare minimum, 1 year before the divorce's initiation.[418] Finally, because the Trojan Horse Strategy anticipates giving at least half of an entity's ownership interest to an ex-spouse, the Trojan Horse Strategy is equally effective in community property and non-community property states. However, we caution that the same transfer restrictions that apply to a DBETT also apply here. For example, transferring community property to a COPE without the consent of both spouses will likely be considered a fraudulent transfer in the event divorce materializes.

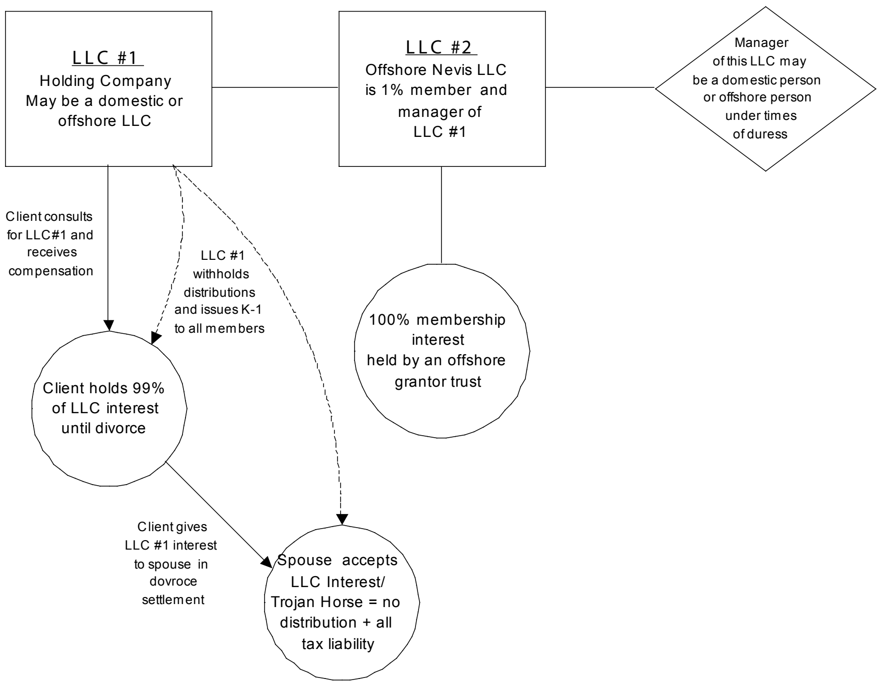
An Illustration and Explanation of the Trojan Horse Strategy

Figure 20.1, below, gives a more detailed illustration of how the Trojan Horse Strategy works. First, as many assets as possible are placed in one or more COPEs (in this illustration, all such entities are collectively referred to as "LLC #1"). Note that although it may not always be feasible to hold mortgaged real estate or one's home in LLC #1, these assets may be effectively shielded via an equity stripping program, wherein LLC #1 would hold the majority of the real properties' equity in the form of un-trapped equity/liquid assets.[419]

Second, an second LLC (LLC #2) is formed, which holds a 1% interest and all management powers in LLC #1. The manager of LLC #2 may, in turn, be the client or a trusted thirty party while the marital seas are calm, although the management should be shifted away from the client at the first sign a divorce may be pending. The membership interest of LLC #2 should be held by an irrevocable trust or by someone other than the client so that LLC #2 is completely independent of the client.

If divorce proceedings commence, then the client's attorney should offer at least half of the client's interest in LLC #1 to his spouse. Since this is the only thing the client has to give (in connection with LLC #1) such an offer makes sense and should be welcomed. The client could possibly even offer all of his interest in LLC #1 if his spouse was willing to make other concessions, such as custody of or favorable visiting rights with the couple's children, for example. Every effort should be made to make the divorce as quick and painless as possible. Once the division of assets is finalized, the bait has been taken and the trap is set. At this point, the client merely has to wait until the end of the taxable year. In the meantime, no distributions are made from LLC #1, although the client may draw funds from the company by rendering consulting services to it in exchange for monetary compensation. Soon after the end of the tax year, LLC #1 will distribute a K-1 to each member. A K-1 is a report given to each LLC member and the IRS stating the tax liability of each member for company gains and losses. Assuming there has been company profit, the client's ex-spouse will essentially receive a tax bill. However, since no distributions have been made to either party to pay for the tax debt, the spouse will now have a tax liability without the means to pay it. The client is now in an extremely advantageous position to negotiate a pennies-on-the-dollar buy-back of the spouse's LLC #1 membership interest in return for alleviating his surprise tax burden.

FIGURE 20.1


LLC #1
Holding Company
May be a domestic or
offshore LLC
LLC #2
Offshore Nevis LLC
is 1% member and
manager of
LLC #1
Manager
of this LLC may
be a domestic person
or offshore person
under times
of duress
Client consults
for LLC#1 and
receives
compensation
LLC #1
withholds
distributions
and issues K-1
to all members
100% membership
interest
held by an offshore
grantor trust
Client holds 99%
of LLC interest
until divorce
Client gives
LLC #1 interest
to spouse in
dovroce
settlement
Spouse accepts
LLC Interest/
Trojan Horse = no
distribution + all
tax liability

CHAPTER TWENTY-ONE

Asset Protection and the IRS

It's important to preface this chapter by saying that if you are liable for a tax, you should resolve the issue by paying or otherwise settling the debt. In egregious circumstances, thwarting the IRS's efforts to assess or collect a tax may constitute a felony. At the same time, there are instances where the IRS is overaggressive in its collection efforts and/or sometimes erroneously pursues people for taxes they don't actually owe. Despite a plethora of cases that demonstrate this, some think they have nothing to fear from the IRS so long as they are honest taxpayers. The following real-life experiences show this is simply not so.

A Bogus 1099

An attorney named Jeff[420] is married with four children. His wife Linda is a stay-at-home mother who has not worked for many years. One day, to her surprise, she received an IRS 1099 form in the mail, generated by a company she'd never heard of, reporting that the company had paid her $350,000. She does not report this as income, since she never received any money. The IRS, however, claimed she was liable for over $100,000 in taxes, based solely on a ½ page, unsigned document sent out by a company that shortly thereafter went out of business. Jeff used his legal expertise to argue that the IRS has no proof of Linda receiving such income. In fact, he said that if the IRS could locate the money, he'd split it with them 50/50.

The IRS disagreed without even auditing the company that generated the form, and a legal battle ensued. Over eight years later, the issue remains unresolved. Fortunately, Jeff has experience representing clients with IRS problems, which saves them tens of thousands of dollars in attorney's fees they'd otherwise have to pay. Nonetheless, Jeff never figured he'd have his own wife for a client.

Case Closed?!

The IRS contacted Chuck, a real estate developer, and claimed he owed $30,000 in back taxes. After his CPA went to bat for him, the tax debt was reduced to around $8,000. Chuck cut a check for that amount and mailed it to the IRS. A few weeks later it was returned, with a letter stating the case was closed and the matter dropped concerning his alleged liability. Several years later, the IRS contacted Chuck again. They said he had never paid the original tax debt, and now owed the IRS over $50,000 due to penalties and interest (this was based on the $30,000 original assessment, not on the subsequent correct assessment of $8,000!). Chuck protested that he had mailed them a check to pay the debt several years earlier. The IRS stated they had no record of ever receiving payment, and that the case had never been closed. What happened as a result? Chuck had $30,000 seized from his bank account, along with 2 plots of land, which were sold to pay off what the IRS claimed he owed, even though he'd already sent them payment in full!

Whether it is incompetence or disregard for law that sometimes leads federal and state tax agencies to wreck the lives of law-abiding citizens, the need for asset protection against such threats is indisputable. However, the IRS is not always bound by the same rules that regular creditors must follow. Let's examine how the IRS differs in powers and collection methodology from that of a standard creditor, and then we'll discuss how to fortify our wealth to counter such powers.

Non-judicial Collection Powers and a Biased Tax Court

In most circumstances, the IRS effectively has power to act as judge, jury, and executioner with regards to assessing a tax, arbitrarily modifying an assessment, imposing tax-related penalties, and collecting on delinquent taxes. This gives the IRS a powerful edge that other creditors don't enjoy. Many people wonder how the IRS could legally 'get away with' such collection activities in light of certain provisions of the U.S. Constitution.

From a legal standpoint, one might argue that numerous U.S. Supreme Court rulings prohibit IRS non-judicial collection activities,[421] which could essentially be considered Bills of Pain and Penalties (such Bills are deemed Constitutionally included under the term "Bill of Attainder" and therefore prohibited by the U.S. Constitution[422]) However, the U.S. Supreme Court has given an exception to the

Constitutional Bill of Attainder prohibition in regards to tax collection activities,[423] although they have been silent regarding whether the IRS could unilaterally assess and collect on tax-related penalties which are not a part of the original deficiency. Nonetheless, the exceeding number of lower court cases supporting the general legality of IRS collection procedure, in regards to both tax debts and tax-related penalties, forces us to plan as if IRS collection activity, when done in accordance with established procedure, is legal even if done without court oversight. It is the author's experience that only a violation of established procedure will result in judicial censure of IRS collection activity; challenging the established procedures themselves is more or less futile. Fortunately, established IRS procedure allows for asset protection against tax claims in many instances (although an individual should *never* do asset protection to attempt to defeat a specific and anticipated tax liability).[424] In the unlikely event such procedure is violated (which may result in the illegal piercing of an asset protection program), taking the matter to court usually results in a win for the taxpayer.

In regards to payment of an erroneous or illegally assessed tax, the general rule is a taxpayer who wishes to dispute an assessment must first pay the tax and then sue for a refund.[425] The one exception to this is the U.S. Tax Court, which a taxpayer may petition before the tax is paid. However, most tax attorneys will tell you that the U.S. tax court, which hears all cases sans jury, is heavily biased towards the IRS (you could also argue the same bias, albeit to a lesser extent, exists in 'normal' courts. A federal judge has even gone on record regarding such bias.[426]) The result of this bias and the legal expectation for one to pay an erroneous tax is that a taxpayer can be at an enormous disadvantage when challenging the IRS, not to mention you don't get reimbursed for your time or legal expenses, or the inconvenience or hardship you suffer for forking over cash you don't really owe to the government. In light of this, asset protection (but only if done as general asset protection, and implemented before a specific tax threat arises) is arguably the best way to level the playing field — we'll discuss why shortly.

The Collection Timeline and Administrative Remedies

Although the IRS can seize assets without court oversight, they are required to follow their own version of due process, which gives us a finite window to legally implement certain asset protection measures after a dispute has arisen. The most critical time window begins after a taxpayer receives a statutory notice of deficiency from the IRS; the IRS will almost certainly have done an audit and/or sent several preliminary letters to the taxpayer before this formal notice. Once the statutory notice is received, a taxpayer generally has 90 days to file a petition with the U.S. Tax Court to challenge the deficiency. If no petition is filed within this period, the IRS may then officially assess the tax, which assessment shall serve as the basis for all future tax liens (both the amount and date of the lien are based on the assessment date) and related collection activity. Although an asset protection program is best set up long before disputes arise, in the event a program isn't already in place it is critical to implement a plan before this final assessment occurs. This 90 day window is typically extended if a petition is filed in time, since the petition will result in a Tax Court appearance date, which will effectively delay the assessment until it's determined in Tax Court.

Tax Court determinations are not final, due to the fact that the U.S. Tax Court is a creature of the legislative rather than judicial branch. This means Tax Court determinations may be reviewed by a 'real' court (which, unlike Tax Court, is created by Article III of the Constitution and is an actual member of the judicial branch) of competent jurisdiction *de novo* (as if the Tax Court trial had never occurred). Practically speaking, however, once Tax Court makes its determination, the tax must be paid before any appeal to a 'real' court of the judicial branch will be heard.[427] Of course, a solid asset protection program may give a client other options besides "pay now and then sue" if a Tax Court determination is unsatisfactory to the taxpayer.

The Fear Factor

It's no secret: the IRS's biggest tool is fear. Every year, just before April 15th, the IRS convicts a few high profile individuals of tax crimes (Wesley Snipes, Pete Rose, Leona Helmsley, *et al*), in order to scare the masses into submission. Fear allows the IRS to get away with things they otherwise couldn't do. Most commonly, it allows the IRS to convince 3rd parties to hand over money and assets they have no actual legal obligation to surrender. For example, we know a man (we'll call him Frank) who placed a large sum of money in a multi-member LLC brokerage account. Unfortunately, Frank was not wise, and he decided to commingle funds by having the LLC write checks to pay his house and car payments for several months. Of course this commingling, if challenged in court, would allow the IRS to argue the LLC was merely Frank's 'alter-ego', which in turn means the judge would likely allow the IRS to seize LLC funds that would normally be off-limits. Nonetheless, even though Frank was commingling, the IRS must as a matter of law litigate before being able to levy LLC assets to satisfy an owner's tax debt. Yet the IRS, being limited in manpower, decided to take a shortcut by foregoing this hassle. They instead wrote a letter to the brokerage firm, telling them to merely hand over LLC funds. Yes, the IRS should have gone to court, but its intimidation factor allowed it to obtain the money outright. Of course if Frank had sued the IRS for a refund, he would likely fail to get the money back, since he had been abusing the LLC form. Therefore, although the IRS was breaking procedure, they knew could get away with doing so. The author's experience is the IRS also sometimes seizes smaller amounts of money, even in violation of its own procedures and established law, if the amounts are so small as to not be worth the taxpayer's time to sue for a refund. If weren't for the fear factor, such shenanigans would be almost nonexistent.

Interestingly enough, the IRS never seized funds in Frank's accounts held by other LLCs, even though the amount seized did not fully satisfy the tax debt. Why? These LLCs were not commingling, meaning that if they seized these funds, and Frank sued, the money would not only likely be ordered returned, but Frank could also sue the collections agent personally for damages. In other words, the IRS will often use fear and intimidation to bend the rules — when it can get away with it. This is why it's especially important to do things 'by the book' when dealing with the IRS, in order to minimize their ability to resort to such underhanded tactics. If Frank hadn't commingled, his LLC would still likely have its assets.

The IRS Can Usually Ignore State and Federal Property Exemptions

The general rule of 'federal law trumps state law' allows the IRS to ignore most state exemptions that protect certain assets from other creditors. Furthermore, state as well as federal law often makes allowances for the IRS to attach property that is off-limits to other creditors or even other federal agencies.[428] For example, Texas state law generally protects 100% of wages[429] and 100% of a person's primary personal residence (a.k.a. "homestead"[430]) from creditors. However, these exemptions provide zero protection against IRS wage garnishment and federal tax liens. Likewise, even if an IRA, annuity, or life insurance policy is exempt from creditor attachment as a matter of state law, it is not protected against the IRS. Even federal exemptions, such as the ERISA anti-alienation provision that otherwise provides unassailable protection for certain pension plans, usually do not protect against IRS liens and levies.[432]

The IRS Typically Has Ten Years to Chase You

Unless the IRS files suit against you in a timely manner (which does not include filing suit in U.S. Tax Court), their ability to levy (collect) a tax expires ten years after the assessment is made.[433] This also means that federal tax liens effectively expire at this time. Because the IRS, relatively speaking, rarely takes a taxpayer to court, they usually won't be able to pursue you beyond this point. However, if the IRS takes you to court before the ten year period expires, then the statute of limitations is extended until the debt is satisfied or becomes unenforceable.[434] Taxpayers whose assets are outside the reach of IRS levies and other non-judicial actions often choose to 'sweat it out' until the ten years are up. A common example of this is when a federal tax lien is placed on real property, and the owner refrains from selling the property until the lien expires, knowing it is very unlikely the IRS will reduce the lien to judgment and foreclose on the property. Note that this ten year statute of limitations is typically shorter than the various statutes of limitation for enforcing the lien of judgment creditors, which often last for twenty years or longer. At the same time, most non-tax judgments are usually settled within a few years or less, due to the fact that both the creditors and their attorneys want to get paid. The IRS, on the other hand, has less of a problem with waiting several years, if need be, before collecting on a debt, although collections agents do have a desire to close cases before they age too long (more on this later.)

The IRS Will Only Devote Limited Resources to a Particular Case... Usually

One aspect that usually makes asset protection versus the IRS easier than versus other creditors is in regards to resources the IRS is willing to dedicate to a given case. Whereas many non-IRS attorneys are willing to devote a large amount of time to a case, even on a contingency fee basis, the IRS in general does not have this luxury. In fact, the IRS only has enough manpower to pursue a fraction of all real or supposed tax delinquencies. Remember, even though the IRS has a workforce numbering in the tens of thousands, their job is to ensure proper taxes are paid by hundreds of millions of U.S. citizens, resident aliens, and non-resident aliens deriving income from within the U.S. If an IRS agent spends too much time on a difficult case, it means he is letting a lot of easy cases slip through his fingers. This hurts his statistics regarding the amount of cases he's closing (which is the most important statistic when determining whether an agent will be promoted or given monetary rewards). Because of this, an IRS agent will often recommend a case be closed as uncollectible if it begins to age. This point is driven home by the April 30th, 1998 testimony of IRS agent Maureen O'Dwyer during the Senate Committee Hearings on IRS Abuse, when she said:

> "A[n IRS] manager who has an aging [tax collection or audit] case in his group will not receive an evaluation that will merit him a monetary award and help him carve out a career path within the Service … the technically weaker managers consistently ordered cases closed, no-change, if they begin to age …
>
> In large case CEP it is standard practice to drop an issue that will delay the closing of a case. Large dollar amounts on major taxpayers are routinely zeroed out in this manner. It matters not that there appears to be an egregious tax abuse, nor that the complexity of the issue requires time to develop. What matters is the manager receives a performance award for having met the case closing deadline timely… The cases that begin to age ordinarily have outstanding issues which have gone

> unresolved due to the complexity of the issues involved and the difficulty of their development, or due to the deliberate procrastination and lack of cooperation on the part of the taxpayer. *Therefore it can be seen that the cases which are closed, no change, under this statistically driven cosmetic deadline are usually large and wealthy taxpayers who have the means to consistently contend and dispute with the IRS.*" [Emphasis is ours.]

Despite the general rule that the IRS lacks the manpower to completely pursue every tax delinquency, keep in mind that a variety of factors may lead the IRS to unleash everything it has against you. It is relatively rare for the IRS to bring out the big guns. For example, out of an estimated 8.6 million taxpayers in 2004 who the IRS claims were liable to pay income taxes but failed to file returns, only about 250 were indicted on tax evasion or similar charges. Nonetheless, if the IRS decides to hit you with everything it has, it can become the most difficult of creditors, with practically unlimited resources. Therefore, every asset protection plan should be reinforced against this contingency.

How Can Asset Protection Help With My Tax Problems?

Despite the advantages the IRS enjoys, protecting assets from federal and state tax claims is not more difficult than protecting against creditors in general, as far as the skilled planner is concerned. This is because there are several asset protection techniques that work against both tax and other creditor claims equally well. Such techniques include:

1) Holding assets in LLCs and limited partnerships, as well as (though somewhat less effective) in corporations.[436]
2) Equity stripping.[437] (Note that equity stripping of accounts receivables (A/R) is only effective for 45 days after a federal tax lien is placed on the A/R.)[438]
3) Offshore asset protection, provided that all reporting requirements are met.
4) Non self-settled irrevocable spendthrift trusts.[439]
5) As a last resort, bankruptcy may discharge certain tax claims, except income tax debts less than three years old are not dischargable.
6) Because state and federal exemptions are generally ineffective against tax collection activity, 401(k), IRA, and other such funds are best protected by investing these funds, to the extent legally permissible, in an offshore LLC with a non-U.S. manager. The offshore manager, of course, is not in the jurisdiction of a U.S. court and thus is not required to obey any U.S. court order to hand LLC funds over to the IRS or any

other creditor.

In addition to the above strategies, keep in mind that the average IRS collections agent or IRS attorney may not be very skilled at piercing a solid program. At the same time, if the IRS does take you to court, they will be able to use the same remedies that other creditors have to attempt to pierce your structure, such as fraudulent transfer law or an alter-ego argument. The best plans, of course, are reinforced against these creditor remedies, and will plan for the (albeit unlikely) possibility that the IRS will litigate their claim.

Asset Protection Strategies to Avoid (Unless You Want to Risk Jail Time)

The two largest pitfalls to avoid, especially when reinforcing a plan against potential tax claims, are badges of fraud and failure to observe reporting requirements. It is even more critical to avoid these pitfalls when doing offshore planning, since a misstep here might subject a debtor to criminal as well as civil penalties.

Avoiding badges of fraud is best done by strictly observing the following:

- Don't do anything on the IRS 'dirty dozen' list. This is a list of transactions, structures, and/or other programs, some of which claim asset protection as a primary or secondary purpose, that the IRS claims are abusive in nature, and which the IRS aggressively pursues. As of the time of this writing, the latest version of the IRS dirty dozen list (2006) may be found online at *http://www.irs.gov/newsroom/article/0,,id=154293,00.html.*
- Be very careful of using any strategy that may be considered an abusive tax shelter. Abusive tax shelters are generally promoted as a means to completely eliminate or drastically reduce income tax liability. One example of an abusive tax shelter is the Pure Trust (discussed in this book's chapter on Trusts for Asset Protection) whose income is falsely advertised as being not subject to income taxes. The same argument is made by promoters who sell corporation soles, as well as many other structures of dubious validity. Although most of these structures aren't abusive as a structure, their overwhelming use in an attempt to circumvent tax laws has led the worst offending programs to automatically raise a red flag in the eyes of the IRS, even if they're used legitimately. Seek the advice of at least one experienced tax professional before buying into any tax shelter that sounds too good to be true.

- Avoid any strategy that lacks economic substance. Such problems are, if challenged in court, usually ruled a sham. An example of such a strategy would be to have an LLC or other entity file a lien against property in order to equity strip it, with out having any basis for the lien. In other words, if there is no valid debt or obligation that the lien secures, the program will probably fall apart under court scrutiny.
- If the IRS has already assessed you for back taxes, it is too late to do most types of asset protection planning. At this point, you need a skilled attorney who will let you know what is and is not acceptable.
- Never, never, never hide income from the IRS, or do anything that involves dishonesty or deception.

In summary, if you follow the rules and know what the IRS can and cannot do, it is possible to achieve excellent asset protection against tax claims. This allows you to negotiate and settle your tax debt with the IRS on your terms, instead of the other way around. Often times an asset protection program enables to a debtor to negotiate a very favorable offer in compromise with the IRS, where they are able to settle their tax debts for as little as ten cents on the dollar. One client used asset protection in conjunction with other negotiating tactics to reduce his alleged tax debt to 1% of what the IRS originally claimed he owed (keep in mind an outcome this favorable is the exception and not the rule, but it is possible!) Above all, play it safe and don't do anything that could turn legal asset protection into a tax evasion conviction.

APPENDIX

The Asset Protection Relative Efficacy Chart

The authors designed this appendix's chart in order to demonstrate how one asset protection strategy might compare to another in various situations. In this chart, various strategies are primarily measured as regards to their strength relative to one another. In other words, its purpose is to show which strategies are weaker or stronger when compared to one another across a wide spectrum of creditor threat scenarios.

Although this is probably the most detailed efficacy chart of its kind, there are many, many variables and contingencies that affect the ultimate success or failure of any given strategy, and it would be nearly impossible to incorporate each variable and contingency in such a chart. When designing this chart, we therefore made the following general assumptions.

- First, we assume each strategy is implemented and structured as skillfully as possible while still remaining true to its description. For example, when rating a TRUST-DAPT (domestic asset protection trust) we assume, except where we explicitly note otherwise, that the trustee(s), grantor(s), and assets are located in one of the eight states that allow self-settled domestic trusts to protect assets. We assume the trust is drafted, funded, and operated correctly. We also assume, except where otherwise noted, that the two to four year statute of limitations (which varies by state) has passed so that the statutory protection is now active.

- We do not categorize or differentiate between strategies according to factors that would not influence that strategy's efficacy. For example, we do not consider whether a self-settled trust (in a state that does not allow such to protect the grantor's assets) was funded by a gift or a transaction that involves an exchange of equivalent value. This is a moot point since, to the extent the grantor retains an interest in or control over trust assets, the courts will not allow such a trust to protect these assets in either event.
- We do consider how likely certain creditor classes are to pursue an asset. For example, the IRS is less likely to take someone to court to attach their assets. In most situations, they attach assets using non-judicial remedies. Therefore, if a particular asset is safe from a non-judicial IRS levy, then it receives a slightly higher rating than it otherwise would; just remember that the IRS *could* use judicial remedies if they really want to. In contrast, a criminal fine or penalty is always a result of judicial action. Therefore, there will always be a judge involved, and in regards to criminal actions a judge is usually willing to go farther than he would in satisfying a private debt. Accordingly, most asset protection structures are given a lower rating when criminal fines or penalties are concerned.
- We did break the type of creditor threat into several categories, since what may be safe from one creditor type may not be safe from another. For example, an ERISA plan is 100% protected against private creditors, but may be forfeit to a federal tax levy.
- Even a poor asset protection might work against an unskilled creditor. For example, a strategy with a rating of 1 may actually have a 30-40% chance of working against an unskilled creditor who may not know how to challenge the transfer, or who may not feel the transfer is worth challenging. For example, if you are an attorney for a credit card company, and you have several cases you are pursuing, and someone with a small $8,000 judgment decides to do some very unsophisticated asset protection, you may leave the debtor alone even though you have a very high chance of still collecting on the debt; the debtor's evasive attempts create more work for you in this case, and you have other, larger debts to collect against. On the other hand, if the U.S. government is aggressively pursuing you for a multi-million dollar judgment it has against you, an unsophisticated asset protection strategy that you implemented right before the judgment was awarded will have almost no chance of working, and might actually make your situation worse.

- Note that transfers offshore, wherein the transferor is demonstrably unable to repatriate the asset, are less damaged by fraudulent transfer issues than a domestic transfer. This is because domestic planning tends to be completely undone in the wake of a fraudulent transfer ruling, but an offshore transfer is not. This does not mean, of course, that a domestic transfer that takes place after creditor threat arises will be considered fraudulent. It only means that if the transfer is deemed fraudulent, the plan will almost always fail.
- Generally speaking, plans that have multiple layers of protection are rated higher than plans that don't. For example, an offshore trust only has one real layer of protection: the claim that the grantor is unable to repatriate the asset. If this defense is set aside by a court, the plan fails (or the grantor goes to jail for contempt if he fails to bring trust assets back within the court's reach.) An offshore LLC, however, may have two layers of defense: charging order protection in addition to the inability to repatriate the asset. It thus scores higher than an offshore trust (remember, we are assuming the offshore LLC is structured correctly, with an offshore manager and other defensive measures in place.) Add a foreign portfolio bond, variable annuity, or variable life insurance policy in a favorable jurisdiction and the plan gains another layer of protection and becomes stronger still.
- Also consider that, while some strategies receive high ratings, they may not be practical or desirable solutions. For example, GIFT2-O, an offshore gift with a valid purpose besides asset protection, is a gift where the transferor retains no rights or interest in the asset. The asset is outside the reach of creditors, but it's also outside the reach of the transferor! Therefore, although this strategy does not involve paying several thousand dollars to a planner, and is fairly effective, it is probably not desirable.
- In the case of equity stripping, we are rating each strategy by the strength of the lien i.e. how likely or unlikely a creditor would be able to have the lien removed. Although commercial equity stripping is very strong, we do not factor into its rating the fact that you still have to protect the loan proceeds (which should be protected using another strategy.) Compare this with an obligation-based private-party lien. It's not as strong as a commercial based lien, but there are no loan proceeds that need protecting, and you're not losing money to thousands of dollars in interest payments each year.
- A "Plan set up in advance" means a plan set up before creditor threat has materialized, but not before the statute of limitations has expired. If a plan is set up and creditor threat arises after the statute of limitations for challenging a transfer has passed, a creditor cannot generally

challenge the transfer, meaning the assets are safe. However, this general rule may not apply in the following situations: assets are transferred to a self-settled trust, or the debt arises from a criminal fine, penalty, or a federal debt.

- Only column 2 of the chart (Private Judgment; Plan Set Up After Threat Materialized) considers a plan's implementation after creditor threats arise. Categories 1 and 3 through 7 involve strategies that are implemented while creditor seas are calm. If one wishes to rate a particular strategy under columns 3 through 7 but *after* the creditor threat has arisen, they should calculate the difference between how the strategy would rate in a column 1 and a column 2 scenario, and subtract that difference from their particular scenario. For example, if one wishes to know how well an offshore COPE (COPE-O) would fair if it's implemented after a federal debt has arisen (column 4), he should subtract column 2 (rating of 8) from column 1 (rating of 9), and subtract the difference (1) from column 4, resulting in a final rating of 8. Using calculations in this manner assumes that the strategy is implemented after the creditor threat has arisen but *before* it is reduced to judgment. No asset protection should be attempted to protect assets from a post-judgment debt.
- We do not rate how an asset protection plan will fare against state tax levies or state criminal fines and penalties, because the amount of protection will vary from state to state. However, one may assume that any particular asset protection plan will generally fare no worse in this instance than it would against a federal tax levy or a federal criminal fine or penalty.

ASSET PROTECTION RELATIVE EFFICACY CHART

	Private Judgment; Plan Set Up in Advance	**Private Judgment; Plan Set Up After Threat Materialized**	**State/ Local Govmt, Debt/ Judgment**	**Federal Debt/ Judgment**	**Federal Tax Debt**	**Criminal Fine/ Penalty**	**Bankruptcy**
GIFT1-D	3	1	1	1	3	0	0
GIFT2-D	5	2	4	4	6	4	4
GIFT1-O	4	3	3	3	5	2	2
GIFT2-O	7	5	6	6	8	5	5
CORP-D	5	4	5	5	6	4	4
CORP-O	8	7	7	6	7	6	6
COPE-D	8	5	8	8	7	8	8
COPE-D-SO	3	2	3	3	5	1	1
COPE-O	9	8	9	9	9	9	9
COPE-O-SO	8	7	7	6	7	6	6
TRUST-R	1	1	1	1	2	0	0
TRUST-SS-I-D	3	2	2	1	2	0	0
TRUST-NSS-I-D	6	4	6	6	5	6	6
TRUST-NSS-I-D-EV	8	5	8	8	5	8	8
TRUST-DAPT	8	1	8	8	4	1	0 (6 after 10 years)
TRUST-OAPT	7	6	6	5	6	5	5 (7 after 10 years)
ES-C	10	9	10	10	10	10	10
ES-OB-INS	7	5	7	7	7	7	7
ES-OB	8	6	8	8	8	8	8
ERISA-NONPAY	10	7	10	9	7	3	10
ERISA-PAY	9	6	9	8	6	2	9
EXEMPT-STATE	9	5	8	8	5	1	5

KEY TO INTERPRETING THE FAR-LEFT COLUMN, WITH NOTES

GIFT1-D = Gifting/Transfers without or for significantly less than full consideration with no viable non-asset protection purpose, or any gift where the transferor retains control and/or continued use, possession, and/or enjoyment of the asset: domestic or offshore but able to repatriate.

NOTES: None.

GIFT2-D = Gifting/Transfers without or for significantly less than full consideration but with a viable non-asset protection purpose (such as estate planning): domestic. Transferor retains "no strings attached" to this transfer.

NOTES: Any debt involving bankruptcy or an actual judgment will almost certainly bring the gift into scrutiny, which results in a lower rating in some circumstances. You're giving up all control and benefit, so this won't be desirable for most people. Giving a gift while retaining control or a beneficial interest in the asset should be treated as a GIFT1-D, even if you secretly retain control or a beneficial interest.

GIFT1-O = Gifting/Transfers without or for significantly less than full consideration and with no viable non-asset protection purpose: offshore and unable to repatriate.

NOTES: The only issue is whether you can repatriate the asset. If you can, the strategy fails. A judge will probably have a hard time believing you didn't retain the ability to repatriate the asset, if you don't have a valid non-asset-protection reason for the gift.

GIFT2-O = Gifting/Transfers without or for significantly less than full consideration but with a viable non-asset protection purpose (such as estate planning): offshore and unable to repatriate. Transferor retains "no strings attached" to this transfer.

NOTES: None.

CORP-D = Transfers to a corporation or IBC involving an exchange of equivalent value: domestic or offshore but able to repatriate.

NOTES: Corporate stock is considered your personal property. A creditor can seize corporate stock, and if a majority of voting stock is seized, the creditor can then vote to liquidate the corporation, meaning your plan has failed.

CORP-O = Transfers to a corporation or IBC involving an exchange of equivalent value: offshore and unable to repatriate.

NOTES: Offshore corporations/IBCs are better than their domestic counterparts, but they are still not as good as an offshore COPE. A court may still award voting *stock to a creditor. Offshore management may not recognize the creditor attachment, but why worry about this vulnerability when you can avoid it by using a COPE?*

COPE-D = Transfers to a COPE (limited partnership, LLC, etc.) involving an exchange of equivalent value: domestic or offshore but able to repatriate.

NOTES: Domestic COPES are vulnerable to fraudulent transfer rulings if not set up in a timely manner, however, they protect well against all creditor threats when fraudulent transfers are not an issue.

COPE-D-SO = Transfers to a COPE with a single owner (LLC, etc.) involving an exchange of equivalent value: domestic or offshore but able to repatriate.

NOTES: Charging order protection may not apply, and a creditor doesn't have to attach >50% of corporate stock to vote a liquidation. This means a single-member COPE will protect assets about as well as a single-owner domestic corporation, or not as well as a multi-owner domestic corporation.

COPE-O = Transfers to a COPE involving an exchange of equivalent value: offshore and unable to repatriate.

NOTES: COPE-Os provide very strong protection if management is offshore, it has a valid business purpose, and there are multiple members. Make it even better by investing COPE-O assets into an offshore VUL, VUA, or portfolio bond.

COPE-O-SO = Transfers to a COPE with a single owner (LLC, etc.) involving an exchange of equivalent value: offshore and unable to repatriate.

NOTES: Charging order may or may not apply, but there's still the defense of being unable to repatriate the asset. Assuming management is offshore, a COPE-O-SO works about as well as an offshore trust.

TRUST-R = Transfers to revocable trusts (domestic or offshore, self-settled or not, with or without consideration).

NOTES: Because the trust's grantor retains the right to revoke the trust and regain full control of trust assets, if a TRUST-R is challenged it will generally fail. The IRS has been known to attach TRUST-R assets using non-judicial remedies.

TRUST-SS-I-D = Transfers to self-settled irrevocable trusts with or without consideration: domestic or offshore but able to repatriate

NOTES: The law of 42 states do not allow self-settled trusts (wherein the grantor is also a beneficiary of the trust) to protect assets from the grantors creditors, to the extent the grantor is a beneficiary of the trust. An irrevocable self-settled trust that is properly structured in one of the eight states that do allow these trusts to protect *assets is classified as a Domestic Asset Protection Trust, or TRUST-DAPT. This chart rates TRUST-DAPTs in a separate category. Self-settled trusts are also subject to the 10-year look-back rule in a bankruptcy proceeding. This book's chapter on trusts examines the look-back rule in detail.*

TRUST-NSS-I-D = Transfers to non-self-settled irrevocable trusts without consideration: domestic or offshore but able to repatriate

NOTES: The IRS may levy a beneficiary's interest in a trust, even if that interest is protected under state law. See Bank One Ohio Trust Company vs. U.S., (CA-6, 94-3974, 1996.) Case law analysis shows this also to be the case where federal criminal penalties or fines are concerned. This book's chapter on exemption planning examines the case law regarding this matter in detail.

TRUST-NSS-I-D-EV = Transfers to non-self-settled irrevocable trusts involving an exchange of equivalent value: domestic or offshore but able to repatriate.

NOTES: These trusts are less susceptible to fraudulent transfer rulings, but are otherwise identical to TRUST-NSS-I-D.

TRUST-DAPT = Transfers to self-settled domestic asset protection trusts (DAPTs), with or without full consideration, where all assets, trustee(s) and grantor(s) are in a DAPT state and the statute of limitations has passed.

NOTES: A DAPT not fitting these criteria should be classified as a normal self-settled, irrevocable trust (TRUST-SS-I-D). If some DAPT assets are located in a state that allows DAPTs and same are in state(s) that do not allow DAPTs, the assets not in a DAPT state should be treated as belonging to a normal self-settled, irrevocable domestic trust. The IRS may levy a beneficiary's interest in a DAPT, even if that interest is protected under state law. See Bank One Ohio Trust Company vs. U.S., (CA-6, 94-3974, 1996.) Case law analysis shows this also to be the case where federal criminal penalties or fines are concerned. This book's chapter on exemption planning examines the case law regarding this matter in detail.

TRUST-OAPT = Transfers to self-settled irrevocable trusts without consideration: offshore and unable to repatriate.

NOTES: A judge will view these trusts the same way he'd view a domestic self-settled trust: no asset protection in 42 states. However, the fact that a grantor is generally unable to repatriate trust assets is a defense that domestic self-settled trusts do not have. Therefore, if the grantor can demonstrate his inability to repatriate trust assets, he should have asset protection. All offshore trusts that have failed have failed because a court was not convinced of a grantor's inability to repatriate trust assets.

ES-C = Commercial Equity Stripping (we assume loan proceeds are unavailable to creditors)

NOTES: Most commercial lenders will not do business with someone who has creditor threats looming. With that said, a commercial lien will almost never be undone. However, one also has to protect the loan proceeds, which must be protected using another asset protection strategy.

ES-OB-INS = Obligation-based liens involving only insiders

NOTES: Using all insiders (as defined under the UFTA) weakens this program somewhat. Obligation based liens do not involve a loan, so there are no loan proceeds that need additional protection.

ES-OB = Obligation-based liens involving at least one significant non-insider

NOTES: This strategy is strong as long as the obligation that the lien secures is demonstrably valid, and the program is set up before creditor threats arise. Obligation based liens do not involve a loan, so there are no loan proceeds that need additional protection.

ERISA-NONPAY = ERISA protected plans (401(k), defined benefit, defined contribution plans, etc.) not in payout status.

NOTES: The IRS is more likely to seize payments from ERISA plans than the corpus of ERISA funds outright, however they may still seize the plan's corpus if they wish. In either event, they often collect against ERISA-governed funds only after other collection attempts have failed. Federal criminal fines and penalties may also attach ERISA funds.

ERISA-PAY = ERISA protected plans (401(k), defined benefit, defined contribution plans, etc.) currently in payout status.

NOTES: Certain creditors may seize ERISA payments as or shortly after they're made, especially if the funds are commingled with other funds.

EXEMPT-STATE = Assets protected from creditors under state law (annuities, life insurance, homesteads, IRAs)

NOTES: Federal tax levies and federal criminal fines and penalties override any protection provided under state law. This book's chapter on exemption planning examines this matter in detail. The purchase of an exempt asset after a creditor threat materializes may not always work due to fraudulent transfer or fraudulent conversion laws.

MODIFICATIONS TO RATINGS

- Any strategy involving a transfer that is an exchange of equivalent value that may assert the transferee in good faith defense (§8(a) of the UFTA) = add 1 to its rating.
- Any transfer that is domestic (or offshore while retaining the ability to repatriate) that leaves the debtor insolvent = subtract 3 from its rating.
- Any transfer offshore (that the debtor is unable to repatriate) that leaves the debtor insolvent = subtract 1 from its rating.

CONCLUSION

The Next (*and most important*) Step

Contact Us Today For the Protection and Peace of Mind You Deserve

All the knowledge in this book is worthless until it is used, and as you have probably already guessed, a holistic wealth preservation plan involves many complexities and is therefore best left to the experts. We have seen countless times where an individual tried to put together their own program, only to get burned because they didn't understand the tax or other ramifications of what they were doing. So your next and most important step is to contact a qualified planner who can help you implement a plan that reinforces your wealth against all threats: creditor and liability threats (lawsuits, divorce, etc.), estate taxes, and economic downturns. We hope this book has amply demonstrated that both of its authors are competent and willing to help you build a financial fortress that will weather whatever lies ahead. Take your next step. Visit either www.assetprotectionattorneys.com or www.pfshield.com to get started. Call 561-953-1050 (Dr. Goldstein's office) or 800-798-2008 (Ryan Fowler's office). The authors' friendly and knowledgeable staffs will be happy to assist you with whatever you may need.

Above all, remember this: the most effective planning is done before the storm clouds gather. The authors are among the most skilled wealth preservation practitioners in the nation, but we must deal with reality. This means that, while in most cases we can still help clients after trouble has already arisen, their plan will usually be more complex, more expensive, and at least a little more vulnerable to a fraudulent transfer or other adverse ruling. In other words, the sooner you implement your asset preservation plan, the better. Act now to get the financial peace of mind you deserve. You will be glad you did!

A Message for Attorneys and Other Professionals: Let's Form a Win-Win-Win Partnership

For the attorney or other professional, this book offers a fundamental insight as to how to properly implement a wealth preservation program. However, this book has also probably convinced you that asset protection is much more complex than many people think. Despite the wealth of knowledge this book contains, you are probably at a loss as to how to get started as an asset protection consultant, or how to properly plan for a clients' specific circumstances.

The truth is no single book will turn you into a competent wealth preservation planner overnight. That will only come with experience and an enormous amount of further study. However, there is a way to provide your clients the solid wealth preservation they need while also becoming progressively more skilled at implementing those plans yourself. If you have one or more clients who are interested in asset protection, estate planning, and/or safeguarding their wealth, we suggest you team up with one of the authors; we are always ready and willing to help. As an attorney you may supervise the project while simultaneously working with us to implement the plan. You will learn the ropes of competent planning while adding a new type of service (and a new income stream) to your practice. Eventually you will be able to handle basic projects on your own. Later on you will be able to tackle more challenging plans. And, if you ever need help, advice, a review of your plan, or even just a 2nd opinion, we are only a phone call away. You will become one of an elite few who truly understand the craft at its most advanced level. It's a win-win-win situation for you, us, and most importantly your client!

REFERENCES

Chapter One

[1] Typically this is 33% of any settlement amount or 40% if the case goes to trial.

[2]As reported in USA Today, March 4th, 2005. See also Newark Star-Ledger, Jan. 20th, 2005, and the Philadelphia/Bloomberg Inquirer, Jan. 20th 2005. Note that due to some technicalities, in February 2007 the New Jersey Supreme Court sent this case back to the superior court for a retrial.

[3]Lawrence J. McQuillan, Hovannes Abramyan, and Anthony P. Archie, with Jeffrey A. Johnson and Anna Erokhina, Jackpot Justice: The True Cost of America's Tort System, p. xiii. Pacific Research Institue, San Francisco, CA. 2007.

[4]Ibid, p. xii.

[5]Ibid, p. xiv.

[6]Ibid, p. xii.

[7]Source: West Legal Directory®. See http://www.profileupdate.findlaw.com.

[8]This information obtained by FOIA request from Transactional Records Access Clearinghouse (TRAC), Syracuse University. See http://trac.syr.edu/tracirs.

[9]Names have been changed.

[10]An excellent resource for exploring the topic of bad faith claims can be found at www.badfaithinsurance.org.

Chapter Two

[11]See FTC v. Affordable Media LLC, 179 F.3d 1228 (9th Cir., 1999); In re: Lawrence, 238 B.R. 498 (Bankr. S.D. Fla. 1999), aff'd 251 B.R. 630 (S.D. Fla. 2000), aff'd 279 F. 3d 1294 (11th Cir. 2002).

[12]This question is answered in the section of chapter 6 entitled "Applicability of State Exemption Laws in Federal Court".

[13]Need citation. I think this case is cited in another chapter already.

[14]See Havoco of America, LTD. v. Elmer C. Hill, 790 So. 2d 1018 (Fla. 06/21/2001).

[15]Countries that have experienced hyperinflation since 1970 include Angola, Argentina, Belarus, Bolivia, Bosnia-Herzegovina, Brazil, Chile, Georgia, Israel, Krajina, Madagascar, Mexico, Nicaragua, Peru, Poland, Republika Srpska, Romania, Turkey, Ukraine, Yugoslavia, Zaire, Zimbabwe. Countries that have experienced hyperinflation between 1921 and 1970 include Austria, China, Free City of Danzig, Germany, Greece, Hungary, Japan, and Russia. See http://en.wikipedia.org/wiki/Hyperinflation#Examples_of_hyperinflation

[16]The U.S. encountered hyperinflation during the Revolutionary War with its continental currency, and also the Eastern Confederate States encountered hyperinflation during the Civil War. See http://en.wikipedia.org/wiki/Hyperinflation#Examples_of_hyperinflation.

[17]See the movie I.O.U.S.A., Roadside Attractions (2008). Commentators in this movie regarding the looming U.S. economic supercrisis include David M. Walker (until recently the U.S. comptroller general), former Commerce Secretary and billionaire Peter G. Peterson, former Fed chairmen Paul Volker and Alan Greenspan, former Treasury Secretaries Paul O'Neill and Robert E. Rubin, billionaire Warren Buffett, congressman Ron Paul, former Congresswoman Cynthia McKinney, and others.

[18]This position is taken in light of §§4(a)(2)(ii), 4(b)(4), and 4(b)(5) of the Uniform Fraudulent Transfers Act (UFTA). A more thorough examination of this scenario is found in chapter 5. Note that as long as a transfer is made to a non-insider

(as defined by the UFTA) while receiving something of equivalent value (even if this leaves the debtor insolvent), the transfer will not automatically be deemed fraudulent. In this instance, it is only when a preponderance of evidence demonstrates actual intent to hinder, delay, or defraud creditors that a transfer is fraudulent. Leaving some assets exposed as a reasonable settlement offer helps demonstrate there is no intent to commit a fraudulent transfer (even though protecting the remaining assets may result in a much more favorable settlement.)

Chapter Three

[19]*United States of America v. Raymond Grant and Arline Grant, (S.D.Fla. 06/17/2005).*

[20]*California Probate Code §15304.*

[21]*This is one of the shortcomings of the offshore trust (which failed to protect assets) in Brown v. Higashi (In re: Case No. A95-00200, Alaska Bankruptcy Court, 1996.)*

[22]*This exemption is found in Title 26 U.S.C. (Internal Revenue Code) §121.*

[23]*In re Turner, 335 B.R. 140 (Bkrpt. N.D. Cal 2005).*

Chapter Four

[24]*Contingency fees typically involve an agreement wherein legal fees are only due if and when the lawsuit is won or settled, and then the attorney usually collects 33-40% of the amount actually collected as compensation for his fees. Some attorneys make their fees payable even if there is no settlement or judgment award, but such fees are rarely actually collected.*

Chapter Five

[25]*FTC v. Affordable Media LLC, 179 F.3d 1228 (9th Cir., 1999); In re: Lawrence, 238 B.R. 498 (Bankr. S.D. Fla. 1999), aff'd 251 B.R. 630 (S.D. Fla. 2000), aff'd 279 F. 3d 1294 (11th Cir. 2002).*

[26]*50 Edw. III (1376) ch. 6. Set out in Am Jur 2d Desk Book Document No. 106.*

[27]*The UFTA is essentially an update of the UFCA. Unlike the UFCA, however, it specifically addresses transfers that are fraudulent as to future creditors as well as existing ones. Also, the word "conveyance" was replaced with "transfer" due to the fact that "conveyance" has a connotation restricting it to personal property transfers. See Uniform Fraudulent Transfer Act, Prefatory Note.*

[28]*W. Prosser, Torts § 105, at 684-685 (4th ed. 1971).*

[29]*A very few states, such as California, consider a fraudulent transfer to be a crime (see Calif. Penal Code §154). Even in California, however, the criminal statute is very rarely enforced.*

[30]*UFTA §5.*

[31]*UFTA §(4)(a)(2).*

[32]*UFTA §(4)(a)(1).*

[33]*This criterion is based on §§4(a)(1)(i),(ii) and 5(a) of the UFTA.*

[34]*§2(a) of the UFTA says "A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets, at a fair valuation." This statute is usually interpreted to mean "debts as they come due" rather than total debt. For example, if a person has $50,000 cash, a $200,000 mortgage, and no other assets, they are generally considered solvent even though their liabilities outweigh their assets, because they are able to make payments on their mortgage in a timely manner. However, if the same individual had $50,000 cash and a $200,000 judgment lien, or a debt of equivalent value that is immediately due and payable, they would be insolvent unless they made an installment arrangement to pay the debt, and made the payments in a timely manner.*

[35]*UFTA §2(b).*

[36]*Tolle v. Fenley 132 P.3d 63, 2006 UT App 78, 546 Utah Adv. Rep. 34 (03/02/2006). Note that §1(3) of the UFTA defines a claim as "a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured" and §1(4) defines a creditor as "a person who has a claim". §1(5) defines a debt as "liability on a claim".*

[37]*This method of determining solvency is not technically set forth in the UFTA, but it is considered by the UFTA from a practical standpoint. Although the UFTA defines a debt as "liability on a claim" in §1(5) (which liability, in regards to a claim being litigated, would not materialize until a settlement or judgment in favor of the creditor is reached), it also says in §4(a)(2) that "[a transfer is fraudulent if] without receiving a reasonably equivalent value in exchange for the transfer*

or obligation, … the debtor …(ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due." The courts generally agree with the foregoing statement. See United States v. Green, 201 F.3d 251, 257 (3d Cir.2000) (citing Baker v. Geist, 457 Pa. 73, 321 A.2d 634 (1974), for the holding that mere "awareness of a probable legal action against a debtor amounts to a debt" for purposes of the Pennsylvania Uniform Fraudulent Conveyances Act); Bradford, 1999 UT App 373 at ¶ 16, 993 P.2d 887; 37 Am. Jur. 2d Fraudulent Conveyances and Transfers § 3 (2001) ("The existence of a debt is a requirement for bringing a fraudulent conveyance action and generally speaking, the awareness of probable legal action against a debtor amounts to a 'debt'".

[38]*UFTA §3(b).*

[39]*UFTA §3(a).*

[40]*UFTA §9.*

[41]*According to §9(a) of the UFTA, a transfer made with actual intent to hinder, delay or defraud a creditor has a statute of limitations of "…4 years after the transfer was made or the obligation was incurred or, if later, within one year after the transfer or obligation was or could reasonably have been discovered by the claimant." [Emphasis is mine.] Some states have an even longer statute of limitations.*

[42]*UFTA 5(b).*

[43]*§4(a) of the UFTA only considers "…if the debtor made the transfer…"; §5(a) only considers "A transfer made… by a debtor…", and §5(b) only considers "A transfer made by a debtor." Nowhere in the Act does the UFTA consider transfers made by non-debtors as being fraudulent. Furthermore, restructuring an entity does not involve a transfer, and is thus not considered anywhere in the UFTA.*

[44]*Ibid.*

[45]*Lakeside Lumber Products, Inc. v. Evans , 2005 UT App 87 (Utah App. 02/25/2005).*

[46]*Walker v. Weese, No. JFM-02-2768 (D.Md. 11/19/2002).*

[47]*See Florida Statutes, Title XV, §222.30.*

[48]*Note, however, that the Florida Supreme Court has ruled that a purchase of a Florida homestead (which is 100% exempt from creditors), even if done with fraudulent intent, is not voidable and is still protected by Florida's exemption laws. See Havoco of America v. Elmer C. Hill, 790 So. 2d 1018 (Fla. 06/12/2001).*

[49]*The chapter in this book on limited partnerships discusses charging order protection.*

[50]*See the chapter in this book entitled "Asset Protection a Judge Will Respect" for more information on how this type of offshore arrangement might work.*

[51]*This is also the case with the bankruptcy code; see title 11 U.S.C. §101(31)(A)(2). Note that the list of who is considered an insider under the UFTA and bankruptcy code is not all-inclusive. Therefore, if the debtor retains too much direct or indirect control over an asset, then notwithstanding the fact that the asset was transferred to a partnership the debtor doesn't control, the partnership may nonetheless be considered an insider.*

[52]*See UFTA §§1(1)(ii), 1(7)(i)(D).*

[53]*Grupo Mexicano de Desarollo, S.A., et al, v. Alliance Bond Fund Inc., et al, 527 U.S. 308 (1999), p. 13.*

[54]*Havoco of America v. Elmer C. Hill, 790 So. 2d 1018 (Fla. 06/12/2001).*

[55]*Ibid, p. 1.*

[56]*This does assume, however, that you don't voluntarily or involuntarily file for bankruptcy. Under §522(p) of the bankruptcy code (title 11 U.S.C.), if one files for bankruptcy within 1215 days of purchasing a homestead, their homestead exemption may not exceed $125,000, state exemption laws to the contrary notwithstanding.*

[57]*Bank of America v. Weese, 277 B.R. 241 (D.Md. 04/29/2002) (see also Walker v. Weese, No. JFM-02-2768 (D.Md. 11/19/2002), and Plaint. No. 17/2001 in the High Court of the Cook Islands), Brown v. Higashi No. A95-00200-DMD (Fed. B. Alaska 03/11/1996), FTC v. Affordable Media LLC, 179 F.3d 1228 (9th Cir., 1999); In re: Lawrence, 238 B.R. 498 (Bankr. S.D. Fla. 1999), aff'd 251 B.R. 630 (S.D. Fla. 2000), aff'd 279 F. 3d 1294 (11th Cir. 2002).*

[58]*Chapter 9 explains how charging order protection protects assets.*

[59]*See, for example, Florida's fraudulent conversion law, Title XV §222.30. This law would cover annuities since annuities are exempt assets, and this law may be used to reverse the purchase of exempt assets if the purchase is done with fraudulent intent.*

[60]*Lakeside Lumber Products, Inc. v. Evans , 2005 UT App 87 (Utah App. 02/25/2005).*

[61]*Grupo Mexicano de Desarollo, S.A., et al, v. Alliance Bond Fund Inc., et al, 527 U.S. 308 (1999). In footnote 6 of this case,*

we find a more detailed explanation of the Supreme Court's position on this matter as follows: "'Our laws determine with accuracy the time and manner in which the property of a debtor ceases to be subject to his disposition, and becomes subject to the rights of his creditor. A creditor acquires a lien upon the lands of his debtor by a judgment; and upon the personal goods of the debtor, by the delivery of an execution to the sheriff. It is only by these liens that a creditor has any vested or specific right in the property of his debtor. Before these liens are acquired, the debtor has full dominion over his property; he may convert one species of property into another, and he may alienate to a purchase. The rights of the debtor, and those of a creditor, are thus defined by positive rules and the points at which the power of the debtor ceases, and the right of the creditor commences, are clearly established. These regulations cannot be contravened or vaired by any interposition of equity'" (quoting Moran v. Dawes, 1 Hopk. Ch. 365, 367 (N.Y. 1825))."

[62]*In re Complaint as to Conduct of Verden L. Hockett, 734 P.2d 877 (Or. 03/31/1987)*

[63]*McElhanon v. Hing 728 P.2d 256 (Ariz. Ct. App. 1 1985).*

[64]*Grupo Mexicano de Desarollo, S.A., et al, v. Alliance Bond Fund Inc., et al, 527 U.S. 308 (1999), p. 22.*

[65]*Ibid, f.n. 6.*

[66]*Morganroth & Morganroth v. Delorean 123 F.3d. 374 (6th Cir. 1997).*

[67]*Ronald J. Fischer v. Donald H. Brancato, et al., No. ED86014 (Mo.App. E.D. 10/25/2005).*

[68]*In re Complaint as to Conduct of Verden L. Hockett, 734 P.2d 877 (Or. 03/31/1987).*

[69]*In re Depamphilis, 153 A.2d 680 (N.J. 07/31/1959).*

[70]*In the Matter of Breen, 113 N.J. 522, 552 A.2d 105 (1989).*

Chapter Six

[71]*Texas Prop. Code, §41.001(b)(2).*

[72]*Texas Prop. Code, §41.001(b)(1), (5), (6), and (7).*

[73]*Texas Prop. Code, §41.001(b)(3).*

[74]*Texas Prop. Code, §41.001(b)(4).*

[75]*Massachusetts homestead exemption is not unlimited, but it is a healthy $500,000. See Mass. Laws ch. 188 § 1.*

[76]*Such states protect 100% of a property's cash value, but only if the property fits within certain size limits. Iowa, for example, only protects a homestead on ½ acre or less of land, if the homestead is located in a town or city. See Iowa Prop. Code, § 561.2.*

[77]*N.C. statutes § 1C 1601.*

[78]*There is conflicting case law on this matter. For example, in Callava v. Feinberg, 2003 WL 22336421 (Fla. App. 3 Dist.), the court held that a personal residence held in a revocable grantor trust has homestead protection under Section 4, Article X of the Florida Constitution. However, in In re Bosonetto, 271 BR 403; 2001 Bankr.lexis 1667 (2001), the court held that real property located in Florida that was held by the trustee of a revocable trust and used as the primary residence of the grantor did not qualify for the homestead exemption. Neither decision overrules the other since one is a state court of appeals and the other is a bankruptcy court.*

[79]*Texas Prop. Code, §42.001(b)(1).*

[80]*Florida statutes, Title XV, §222.11.*

[81]*New York Personal Prop. Code, Article 3-A, §48-a(2).*

[82]*Texas Prop. Code, §42.005. See also the federal Child Support Enforcement Act of 1975. This Act prohibits other laws from exempting income from child support payments. Because it is a federal law, it generally supersedes state laws.*

[83]*Title 15 U.S.C. chapter 41.*

[84]*Title 15. U.S.C., §1673(a).*

[85]*Utah Code §78-23-5(1)(a)(xii).*

[86]*Alabama Code, §27-15-26.*

[87]*Havoco of America v. Elmer C. Hill, 790 So. 2d 1018 (Fla. 06/12/2001).*

[88]*Title 29 U.S.C. chapter 18.*

[89]*29 U.S.C. §1056(d)(1),*

[90]*Patterson v. Shumate, 504 U.S. 753 (1992).*

[91]The primary statutes/regulations involved here are 29 U.S.C. §1056(d)(1), 26 U.S.C. 401(a)(13)(C), and 26 C.F.R. §1.401(a)-13(b)

[92]29 C.F.R. § 2510.3-3.

[93]In re Watson, 214 BR 597 (Bankr 9th Cir 1997); In re Witwer, 148 BR 930 (Bankr CD Cal 1992), aff'd 163 BR 614 (Bankr 9th Cir 1994).

[94]In re Witwer, 148 B.R. 930 (Dec., 1992, Cal.); In re Lane, 149 B.R. 760 (Jan., 1993, N.Y.); In re Hall, 151 B.R. 412 (Feb., 1993, Michigan); In re Watson, 192 B.R. 238 (Feb., 1998, Nevada), affd. 22 EBC 1091 (9th Cir. 1998).

[95]Raymond B. Yates, M.D., P.C. Profit Sharing Plan v. Hendon, Trustee, 124 S. Ct. 1330 (March 2, 2004).

[96]See In re Lane, 149 B.R. 760, 763 (Bankr. E.D. N.Y. 1993).

[97]26 CFR 1.401(a)-13(b), 29 USC §1144(d).

[98]United States v. Tyson, no. 02-X-73808 (E.D. Mich. April 9, 2003); United States v. Clark, no. 02-X-74872 (E.D. Mich. June 11, 2003); United States v. Rice, 196 FSupp. 1196 (N.D. Okla. 2002).

[99]26 U.S.C. §414(p), 29 USC §1056(d)(3).

[100]26 U.S.C. §401(a)(13)(C), 29 USC §1056(d)(4).

[101]26 C.F.R. 1.401(a)-13(b)(2).

[102]29 U.S.C. §1144(d).

[103]McIntyre v. USA (9th Cir. App. case No. 98-17192 (2000)); United States v. Tyson, no. 02-X-73808 (E.D. Mich. April 9, 2003); United States v. Clark, no. 02-X-74872 (E.D. Mich. June 11, 2003); United States v. Rice, 196 FSupp. 1196 (N.D. Okla. 2002).

[104]United States v. Tyson, no. 02-X-73808 (E.D. Mich. April 9, 2003); United States v. Clark, no. 02-X-74872 (E.D. Mich. June 11, 2003); United States v. Rice, 196 FSupp. 1196 (N.D. Okla. 2002).

[105]McIntyre v. USA (9th Cir. App. case No. 98-17192 (2000)); United States v. Sawaf, 74 F.3d 119 (6th Cir. 1996); In re Jeffrey L. Berry 268 B.R. 819 (Bankr. E.D. T.N. 2001).

[106]Title 26 USC §72(t).

[107]Ibid.

[108]See Title 26 USC §4975 and IRS publication 590 for more on prohibited transactions, investments, and disqualified persons. IRS publication 560 discusses such with regards to SEP or SIMPLE IRAs.

[109]Title 26 USC §408(a)(3).

[110]The bankruptcy exemptions discussed herein include changes to bankruptcy law due to the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005.

[111]Title 11 USC §303(b).

[112]Title 11 USC §522(b)(3)(a).

[113]Title 11 USC §522(p). This amount is indexed and may rise in subsequent years according to inflation.

[114]Title 11 USC §522(n).

[115]Ibid.

[116]Ibid.

[117]Ibid.

[118]As defined in Title 26 USC §530(b)(1).

[119]Title 11 USC §541(5).

[120]The FDCPA is found in title 28 USC Chapter 176.

[121]FDCPA §3014(a).

[122]FDCPA §3001(a).

[123]FDCPA §3002(3)(B).

[124]See FTC v. National Business Consultants, Inc. 376 F.3d 317; (5th Cir. La., June 25, 2004); U.S. v. Phillips, 50 Fed. Appx. 303; (6th Cir. Ky.., Nov. 6, 2002); Bosarge v. U.S. Dept. of Education, 5 F.3d 1414; 93-2 U.S. Tax Cas. (CCH) P50,590; 72 A.F.T.R.2d (RIA) 6528; (11th Cir. Al., Nov. 1, 1993).

[125]Pierce v. U.S., 232 B.R. 333; (U.S.D.C., E.D.N.C., Jan. 27, 1999.)

[126]ERISA is an acronym for Employee Retirement Income Securities Act. It is a body of federal law (codified in Title 29 U.S.C. chapter 18) that governs most non-governmental employee retirement plans.

[127]Title 26 USC §72(t).

Chapter Seven

[128]Alaska Stat. §34-15-40; Ha. Rev. Stat. §509-2; Tenn. Code Ann. §66-1-109; Ver. Stat. Ann. Title 15 §67.

[129]Janet D. Ritsko, Lien Times in Massachusetts: Tenancy by the Entirety After Coraccio v. Lowell Five Cents Savings Bank, New England Law Review, vol. 30, no. 1, Fall 1995, fn 16.

[130]Ibid.

[131]See United States v. Sandra L. Craft, 535 U.S. 274 (2002).

[132]Notice 2003-60, I.R.B. 2003-39, 9/11/03.

[133]Coraccio v. Lowell Five Cents Savings Bank, 415 Mass. 145, 612 N.E.2d 650 (1993) (No. 92-P-0175).

[134]Janet D. Ritsko, Lien Times in Massachusetts: Tenancy by the Entirety After Coraccio v. Lowell Five Cents Savings Bank, New England Law Review, vol. 30, no. 1, Fall 1995.

[135]Berlin v. Pecora, So.2d, 2007 WL 2710764 (Fla. 4th DCA Sep 19, 2007); Beal Bank SSB v. Almand & Assoc., 780 So.2d 245 (Fla. 2001).

[136]Berlin v. Pecora, So.2d, 2007 WL 2710764 (Fla. 4th DCA Sep 19, 2007).

[137]McIntyre v. USA (9th Cir. App. case No. 98-17192 (2000)).

[138]Ariz. rev. stat. §25-215.

[139]State ex rel Industrial Commission of Arizona v. Wright, 2002.AZ.0000047 (Ariz.App.Div.1 04/02/2002); Schilling v. Embree, 118 Ariz. 236, 239, 575 P.2d 1262, 1265 (App. 1977).

[140]Nev. rev. stat. §123.090.

[141]Tex. Fam. Code. Ann. §3.202(b), §3.202(d).

[142]DeElche v. Jacobson, 95 Wn.2d 237, 245, 622 P.2d 835 (1980); 104 Wash. 2d 78, 701 P.2d 1114 (1985).

[143]Calif. Fam. Code §910(a); Id. Code §32-912; La. Civ. Code. Ann. Art. 2364; N.M. Stat. Ann. §40-3-10; Wis. Stat. Ann. §766.55(2)(b).

[144]U.S. v. Bryce W. Townley, No. CS-02-0384-RHW (USDC E. Wash., Jul. 29, 2004). Note the following excerpt from this case: "…a transfer of property made with actual intent to delay, hinder, or defraud a creditor is prohibited… Mr. Townley stated in his deposition that he was concerned about potential 'lawsuits from the exposure we had from liability from troubled boys in the State of Washingtion.' (Ct. Rec. 58, Ex. 1). Additionally, Mr. Townley stated that it was his goal to protect his assets from anyone who might get a judgment against him… Plaintiff asserts that Mr. Townley's statements that he intended to protect his assets from anyone who might get a judgment against him is conclusive, direct evidence of intent to hinder, delay, or defraud. The Court agrees." [emphasis is mine]

Chapter Eight

[145]Trustees of Dartmouth College v. William H. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

[146]Even today, corporations are used for non-business purposes. The corporation sole is a religious entity, and many if not most cities are corporate entities.

[147]Bruce Brown, The History of the Corporation, vol. I (2003) p. 2.

[148]Joseph S. Davis, Essays in the Earlier History of American Corporations, vol. II (1917), p. 24.

[149]Lawrence M. Friedman, A History of American Law, (3rd ed., 2005) p. 131.

[150]Ibid.

[151]Santa Clara County V. Southern Pacific Railroad Company, 118 U.S. 394 (1886.)

[152]Found in Title 26 U.S.C.

[153]See Chapter 143 RSMo. §143.071.2 and Chapter 147 RSMo. §147-010.1, respectively. Note that there are a few states that levy taxes on LLCs, but such taxes are minimized or avoided if a limited partnership is formed (for example, Pennsylvania,

or a flat-tax of $800 imposed annually in California limited partnerships vs. a tax of $800-$12,590 levied on LLCs in proportion to their gross receipts). Therefore, even an LLC may not always be the entity of choice from a tax standpoint.

[154]*In regards to veil-piercing issues involving LLCs, IRS ILM 199930013 (1999) states, "There is an extensive discussion of [the veil-piercing] issue in a 1994 law review article. Fox, Piercing the Veil of Limited Liability Companies, 62 Geo. Wash. L. Rev. 1143 (1994). This article discusses some of the factors which have been used to disregard corporate entities: occurrences of fraud, inadequate capitalization of the corporate entity, failure to adhere to corporate formalities (such as commingling of funds), and abuse of the corporate entity so as to amount to complete dominance by the shareholder or shareholders. Id. at 1155. The article concludes that the failure to adhere to corporate formalities factor may be difficult to apply in the LLC context since an LLC by its very nature does not involve the formalities of a corporation. Id. at 1172. The article also concludes that lack of separateness should not be a factor because LLCs are intended to be managed by their members. Id. at 1174."*

[155]*Most states allow the formation of Professional Limited Liability Companies (PLLCs), and some allow standard LLCs to perform professional services if duly licensed, however California allows neither. See California corporations code §17375.*

[156]*Garcia v. Coffman, 124 N.M. 12, 946 P.2d 216 (N.M.App. 06/17/1997)*

[157]*Norris Chemical Company v. Ingram, 139 Ariz. 544; 679 P.2d 567; (1984 Ariz.)*

[158]*Some (but not all) states prohibit failure to observe corporate formalities from being a reason to disregard the corporate veil. For example, California Corporations Code §300(e) states "The failure of a close corporation to observe corporate formalities relating to meetings of directors or shareholders in connection with the management of its affairs, pursuant to an agreement authorized by subdivision (b), shall not be considered a factor tending to establish that the shareholders have personal liability for corporate obligations."*

[159]*See IRS ILM 199930013 (1999). A relevant excerpt on page 3 is as follows: "There is an extensive discussion of [veil piercing] in a 1994 law review article. Fox, Piercing the Veil of Limited Liability Companies, 62 Geo. Wash. L. Rev. 1143 (1994). This article discusses some of the factors which have been used to disregard corporate entities… The article also concludes that lack of separateness should not be a factor because LLCs are intended to be managed by their members. Id. at 1174." [Emphasis is ours.]*

[160]*Wallace v. Wood, 752 A.2d 1175, 1184 (Del. Ch. 1999)*

[161]*IBC Mfg., 1999 WL 486615 at *4. See also Thomas, 104 F. Supp. 2d at 928 (favorably citing IBC Mfg. for the proposition that fraud is a requisite element of a claim to pierce the corporate veil under Tennessee law).*

[162]*Norris Chemical Company v. Ingram, 139 Ariz. 544; 679 P.2d 567; (1984 Ariz.)*

[163]*J-R Grain Company v. FAC, Inc., 627 F.2d 129 (8th Cir.1980). (The court ruled that inadequate capitalization is to be measured only at the time of its formation. A corporation that was adequately capitalized when formed but becomes insolvent afterwards is not undercapitalized.)*

[164]*Delaware Code, Title 8, §325(b).*

[165]*Nevada Revised Statutes, §78.747(1). In Nevada, the alter ego theory is not asserted in a separate suit, rather the grounds for such is determined during the pre-trial discovery process. See Levinson v. District Court, 857 P.2d 18 (Nev. 07/29/1993) "The district court determined that the parties should first engage in discovery to ascertain whether Read could prove her alter ego theory, and thereafter return to the court if the evidence warranted further proceedings." See also Semenza v. Caughlin Crafted Homes, 901 P.2d 684 (Nev. 8/24/1995) "The Semenzas admitted that the discovery process revealed that Means was not the alter ego of Caughlin [and as a result the alter ego claim was dismissed]."*

[166]*California Corporations Code, §309(c).*

[167]*Written Testimony of K. Steven Burgess, Director, Examination Small Business/Self Employed Division, Internal Revenue Service, Before Senate Committee on Homeland Security And Governmental Affairs, Permanent Subcommittee on Investigations, Hearing on Company Formations: Minimal Ownership Information Is Collected and Available. (November 14, 2006.)*

[168]*See Drenis v. Haligiannis, 452 F.Supp.2d 418 (S.D.N.Y. 2006), an excerpt of which says: "Typically where there is a conflict of law in cases involving tort claims, New York applies an 'interest analysis' to identify the jurisdiction that has the greatest interest in the litigation based on the occurrences within each jurisdiction, or contacts of the parties with each jurisdiction, that relate to the purpose of the particular law in conflict. Pension Comm. of Univ. of Montreal Pension Plan v. Banc. of Am. Secs., LLC, 446 F.Supp.2d 163, 192 (S.D.N.Y.2006) (internal quotation marks and citation omitted). When the law is one which regulates conduct, such as fraudulent conveyance statutes, see GFL Advantage Fund, Ltd. v. Colkitt, 03 Civ. 1256, 2003 WL 21459716, at *3 (S.D.N.Y. June 24, 2003), the law of the jurisdiction where the tort occurred will generally apply because that jurisdiction has the greatest interest in regulating behavior within its borders, Pension Comm., 446 F.Supp.2d at 192 (quoting GlobalNet Financial.com, Inc. v. Frank Crystal & Co., Inc., 449 F.3d 377, 384 (2d Cir.2006).) A tort occurs in the place where the injury was inflicted, which is generally where the plaintiffs are located. Id. (quoting Cromer Fin. Ltd. v. Berger, 137 F.Supp.2d 452, 492 (S.D.N.Y.2001))."*

[169]*Higashi v. Brown, In re: Case No. A95-00200-DMD (Fed. B. Alaska, 2006.) Note that this or very similar tests seem to now*

be the norm in most U.S. states.

[170]*Footnote 1 from Butler v. Adoption Media, LLC is as follows: "Under the "internal affairs" doctrine, which is followed in most states, the law of the state of incorporation governs liabilities of officers or directors to the corporation and its shareholders. Shaffer v. Heitner, 433 U.S. 186, 215 n. 44, 97 S.Ct. 2569, 53 L.Ed.2d 683 (1977); see also CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 89, 107 S.Ct. 1637, 95 L.Ed.2d 67 (1987); Rest. (Second) of Conflict of Laws § 309 and comment (a). Internal corporate affairs involve those matters that are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders. Edgar v. MITE Corp., 457 U.S. 624, 645, 102 S.Ct. 2629, 73 L.Ed.2d 269 (1982); see Rest. (Second) of Conflict of Laws § 313, comment (a). In general, courts in California follow this rule and apply the law of the state of incorporation in considering claims relating to internal corporate affairs. See Cal. Corp.Code § 2116 (directors of foreign corporation transacting intrastate business are liable to corporation for making of unauthorized dividends, purchase of shares or distribution of assets of false certificates, reports or public notices or other violation of official duty according to applicable laws of state of incorporation); see also Batchelder v. Kawamoto, 147 F.3d 915, 920 (9th Cir.1998)."*

[171]*Butler v. Adoption Media, LLC, 2005 WL 2077484 (N.D.Cal.).*

[172]*Greenspun v. Lindley 36 N.Y.2d 473; 330 N.E.2d 79; 369 N.Y.S.2d 123; 1975 N.Y. LEXIS 1826; 88 A.L.R.3d 697. One should note that this case involved a dispute between a business trust's trustees and its shareholders, which the court held was analogous to a dispute between the directors and shareholders of a standard corporation.*

[173]*The IRS substantiates the validity of multi-member disregarded entities in Rev. Rul. 2004-77.*

[174]*IRS Private Letter Ruling (PLR) 0107025,*

[175]*United States V. Craft, 535 U.S. 274 (2002). The court held that an IRS tax lien could attach to property held as tenants-by-the-entirety, even if only one spouse owed the IRS a delinquent tax debt.*

[176]*Furthermore, financial privacy should never be used to illegally hide reportable income.*

[177]*Anonymous LLCs are explained in detail in this book's chapter regarding limited liability companies.*

[178]*Petition of Simrak, 61 Nev. 431, 132 P. 2d 605.*

[179]*Schwabacher v. Zobrist, 102 Nev. 55, 714 P.2d 1003 (1986).*

[180]*Nevada AGO 38 (6-7-1921).*

[181]*Nevada Revised Statutes, §78.240.*

Chapter Nine

[182]*Eder, Limited Liability Firms Abroad, 13 Univ. Pitt. L. Rev. 193 (1952).*

[183]*WARNING: because Louisiana has not adopted the ULPA, RULPA, the Uniform Partnership Act (UPA) or its revisions (RUPA), some of this chapter may not apply in Louisiana. The authors are, however, familiar with Louisiana case law regarding asset protection, and are able to protect Louisiana-situs property as well as in any other state. Louisiana does allow the formation of limited liability companies.*

[184]*The three-tiered corporate management structure consists of the stockholders, who elect the board of directors to oversee strategic company decisions and who in turn hire corporate officers, who run the day-to-day affairs of the corporation.*

[185]*Title 26 U.S.C. §§704(a), (b).*

[186]*Title 26 U.S.C. §731. See also §§704(c), 736, 737, and 751.*

[187]*Title 26 U.S.C. §721(a).*

[188]*Ibid.*

[189]*Title 26 U.S.C. §351.*

[190]*See Title 26 U.S.C., Subtitle A, Chapter 2. As of 2007, self-employment taxes are 15.3% of the first $94,000 of taxable income, and 2.9% of any income in excess of $94,000.*

[191]*Title 26 U.S.C. §734(b). Note that a §754 election must be in effect at the time of sale for this benefit to be realized.*

[192]*Title 26 U.S.C. §743(b). Note that a §754 election must be in effect at the time of sale for this benefit to be realized.*

[193]*Title 26 U.S.C. §752.*

[194]*RULPA (2001), §113.*

[195]*Ibid.*

[196]*Revised Uniform Partnership Act of 1997 (RUPA), §504.*

[197]*Ibid.*

[198]*Ibid.*

[200]*RULLCA, §503.*

[201]*Calif. Corp, Code, §15907.03.*

NRS §87A.480(2). Note that the charging order provision is different for Nevada LLCs. NRS 86.401 does not provide for the foreclosure of a charging order, Both the LP and LLC Nevada statutes state that the charging order is the exclusive remedy of a creditor of an LLC's member.

[202]*O.S. Title 18, §18-2034.*

[203]*LFC Marketing Group, Inc. v. Cebe W. Loomis, 116 Nev. 896; 8 P.3d 841 (Nev. S.C., 2000) "We recognize … that there are other equities to be considered in the reverse piercing situation -- namely, whether the rights of innocent shareholders or creditors are harmed by the pierce."; Floyd v. I.R.S., 151 F.3d 1295, 1300 (10th Cir. 1998) "In addition, the reverse-pierce theory presents many problems. … third parties may be unfairly prejudiced if the corporation's assets can be attached directly. Although … our particular concern was with non-culpable third-party shareholders of the corporation being unfairly prejudiced, no greater culpability should attach to the third-party corporate creditors harmed by reverse-piercing in this case."; Hamilton v. Hamilton Properties Corp., 186 B.R. 991, 1000 (Bankr. D. Col. 1995); "The reverse piercing theory is an aberration which, if invoked, would prejudice . . . the rightful creditors of the corporation whose assets are subsumed for the benefit of the creditors of the individual. What of the creditors of [the corporation] who relied on its separate corporate existence in doing business with it?"); Cargill, Inc. v. Hedge, 375 N.W.2d 477, 479 (Minn. 1985) (holding that in considering propriety of reverse pierce, "also important is whether others, such as a creditor or other shareholders, would be harmed by a pierce").*

[204]*Title 26 U.S.C. §2503(b). As of 2006, the $10,000 annual exclusion amount has been indexed to $12,000.*

[205]*The first of many cases to uphold the use of family limited partnerships for estate tax savings are Watts v. Commissioner, 823 F.2d 483 (11th Cir. 1987) and Harrison v. Commissioner, 52 T.C.M. 1306 (1987). In Watts, the valuation discount was 35%. In Harrison, the discount was 45%.*

[206]*Albert Strangi v. Commissioner of Internal Revenue, 417 F.3d 468 (5th Cir. 07/15/2005).*

[207]*Kimbell v. United States, 371 F.3d 257, 5th Cir. 2004.*

[208]*United States Tax Court Estate of Albert Strangi, Deceased, Rosalie Gulig, Independent Executrix, Petitioner V. Commissioner Of Internal Revenue, 115 T.C. 478 (2000).*

[209]*Knockout Blow?, Michael E. Kitces, published online at http://www.financial-planning.com/pubs/fp/20051001024.html.*

[210]*In re Turner, 335 B.R. 140 (Bkrpt. N.D. Cal 2005). A relevant excerpt from this case states, "an entity or series of entities may not be created with no business purpose and personal assets transferred to them with no relationship to any business purpose, simply as a means of shielding them from creditors. Under such circumstances, the law views the entity as the alter ego of the individual debtor and will disregard it to prevent injustice."*

[211]*Ibid.*

Chapter Ten

[212]*LLC or LLC-type entities emerged in Portugal (1917); Brazil (1919); Chile (1923); France (1925); Turkey (1926); Cuba (1929); Argentina (1932); Uruguay (1933); Mexico (1934); Belgium (1935); Switzerland (1936); Italy (1936); Peru (1936); Columbia (1937); Costa Rica (1942); Guatemala (1942); and Honduras (1950). See Eder, Limited Liability Firms Abroad, 13 Univ Pitt L Rev 193 (1952).*

[213]*Cunningham, Drafting Limited Liability Operating Agreements, p. 1-8, Aspen Publishers (2006).*

[214]*An LLC desiring C corporation tax status files the election with IRS form 8832. An LLC desiring S corporation tax status completes forms 8832 and 2553.*

[215]*IRS form 2553 Instructions, p. 1.*

[216]*Reference the California and Pennsylvania statutes regarding this here.*

[217]*In re: Ashley Albright, Case No. 01-11367 (Bkrptc.D.Col. 04/04/2003).*

[218]*For example, IC 23-18-6-4.1 of Indiana's LLC act states "If a limited liability company has one (1) member, an assignee of an interest may become a member in accordance with the terms of an agreement between the assignor and the assignee."*

[219]*Crocker National Bank v. Perroton, (208 Cal. App. 3d 1, 1989); Hellman v. Anderson, (233 Cal. App. 3d 840, 1991).*

[220]*In re: Ehmann (2005 WL 78921 (Bankr. D. Ariz. 2005)).*

[221]*Crocker National Bank v. Perroton, (208 Cal. App. 3d 1, 1989); Hellman v. Anderson, (233 Cal. App. 3d 840, 1991).*

[222]*LFC Marketing Group, Inc. v. Cebe W. Loomis, 116 Nev. 896; 8 P.3d 841 (Nev. S.C., 2000).*

[223]*Floyd v. I.R.S., 151 F.3d 1295, 1300 (10th Cir. 1998).*

[224]*See FTB form 568 tax booklet, 2007.*

[225]*Calvert v. Huckins, 875 F. Supp. 674 (E.D. Cal. 1995)*

[226]*The reasons a judge may use for disregarding segregation of liability between related business entities is found in the following cases: Roman Catholic Archbishop v. Superior Court, supra, 15 Cal. App. 3d at pp. 406, 411; Associated Vendors, Inc. v. Oakland Meat Co., supra, 550 Cal. App. 2d at pp. 838-839; Tomaselli v. Transamerica Ins. Co. (1994) 25 Cal. App. 4th 1269, 1285 [31 Cal. Rptr. 2d 433]; Alberto v. Diversified Group, Inc., supra, 55 F.3d at p. 205; Talbot v. Fresno-Pacific Corp. (1960) 181 Cal. App. 2d 425, 432 [5 Cal. Rptr. 361].*

[227]*Depending on the state the medical clinic operated in, a professional LLC (PLLC) may be appropriate instead of a standard LLC.*

[228]*This case was reported in USA Today, March 4th, 2005. See also Newark Star-Ledger, Jan. 20th, 2005, and the Philadelphia/Bloomberg Inquirer, Jan. 20th 2005. Note that due to some technicalities, in February 2007 the New Jersey Supreme Court sent this case back to the superior court for a retrial.*

[228]*Names have been changed.*

[229]*Title 26 U.S.C. § 1442.*

[230]*Ibid.*

[231]*An offshore LLC taxed as a disregarded entity annually files IRS form 8858; form 8865 is filed if it is taxed as a partnership.*

[232]*FTB form 568 booklet (2007), p. 5.*

[233]*Butler v. Adoption Media, LLC, 2005 WL 2077484 (N.D.Cal.).*

[234]*A single-member LLC's income, if any, is reported on its owner's 1040 Schedule C tax return, unless the LLC has elected to be taxed as a corporation.*

[235]*The efficacy of the DEMMLLC is validated by IRS Rev. Rul. 2004-77.*

[236]*If a grantor trust was revocable, a judge could order the LLC's other member to revoke the trust, leaving an LLC that only has one member and possibly no charging order protection. Therefore, a grantor trust when used in a DEMMLLC context should always be irrevocable for the greatest asset protection.*

Chapter Eleven

[237]*Gaudiosi, Monica M. (April 1988), "The Influence of the Islamic Law of Waqf on the Development of the Trust in England: The Case of Merton College", University of Pennsylvania Law Review 136 (4): pp. 1244-5.*

[238]*Hudson, A. (2003), Equity and Trusts (3rd ed.), Cavendish Publishing, ISBN 1-85941-729-9, p. 32. See also the Wikipedia entry on Trust Law as found at http://en.wikipedia.org/wiki/Trust_law.*

[239]*Title 26 U.S.C.*

[240]*For example, the Florida Trust Code, § 736.0505 (1)(a) provides that "The property of a revocable trust is subject to the claims of the settlor's creditors during the settlor's lifetime to the extent the property would not otherwise be exempt by law if owned directly by the settlor."*

[241]*See for example Texas Trust Code, § 112.035(d) "If the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of his beneficial interest does not prevent his creditors from satisfying claims from his interest in the trust estate." Another example is found in the Florida Trust Code, § 736.0505(1)(b) states that "With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit…"*

[242]*The eight states that have passed domestic asset protection trust legislation are: Alaska, Delaware, Missouri, Nevada, Rhode Island, South Dakota, Utah, and Oklahoma.*

[243]*There are exceptions to this rule. Alaska, for example, requires a trust to be registered. See A.S. § 13.36.005.*

[244]*See IRS form SS-4, p. 2.*

[245]*IRC §2513(a)(1), Treas. Reg. 25-2513(1)(a).*

[246]*For 2007, this rate is 35% of taxable income over $10,450. 2007 income under $10,450 is taxed progressively, but at a lower rate.*

[247]*Simple Trusts are defined in §651 of the IRC. For Complex Trusts, see § 661.*

[248]*There are some situations where an individual other than the grantor is used to measure when the trust must expire under the rule against perpetuities, however such situations are rare and are thus not discussed herein.*

Chapter Twelve

[249]*United States of America v. Raymond Grant and Arline Grant, (S.D.Fla. 06/17/2005).*

[250]*Texas Property Code, §112.035(b).*

[251]*Bank One Ohio Trust Company, N.A. v. United States of America, 80 F.3d 173 (6th Cir. 1996). See also United States v. Rye, 550 F.2d 682, 685 (1st Cir. 1977); United States v. Dallas Nat'l Bank, 152 F.2d 582, 585 (5th Cir. 1945); First Northwestern Trust Co. of South Dakota v. Internal Revenue Service, 622 F.2d 387, 390 (8th Cir. 1980); Leuschner v. First Western Bank & Trust Co., 261 F.2d 705, 707-708 (9th Cir. 1958).*

[252]*IRS ILM 199930013 (4/18/1999).*

[253]*UFTA §4(a)(2).*

[254]*See IRS Gen. Counsel Memo. 39503.*

[255]*FTC v. Affordable Media LLC, 179 F.3d 1228 (9th Cir., 1999); In re: Lawrence, 238 B.R. 498 (Bankr. S.D. Fla. 1999), aff'd 251 B.R. 630 (S.D. Fla. 2000), aff'd 279 F. 3d 1294 (11th Cir. 2002); S.E.C. v. Bilzerian, 131 F. Supp. 2d 10 (D.D.C. 2001); and Eulich v. U.S., 94 A.F.T.R.2d 2004-5550 (N.E. Tex 2004).*

[256]*FTC v. Affordable Media LLC, 179 F.3d 1228 (9th Cir., 1999) at 1241.*

[257]*Title 26 U.S.C. §679(a).*

[258]*Oklahoma allows one to protect up to $1 million in assets in a revocable DAPT (Title 31 O.S. § 31-10). All other pro-DAPT states require a DAPT to be irrevocable. Colorado may also have DAPT legislation, however that statutes are not entirely clear as to this matter.*

[259]*This time period depends on a state's statute of limitations. Most states have a four year statute, however Nevada's statute is for two years, or six months after a transfer was discovered or reasonably should have been discovered by a creditor. See NRS 166.170.*

[260]*For an analysis of why this is so, see the section in this book entitled "Where Should I Form My Limited Liability Entity? (Considering Choice-of-Law and Other Issues)" as found in the chapter on Corporations and Limited Liability Concepts. This analysis discusses choice-of-law issues with regards to LLCs, but it equally applies to trusts.*

[261]*Bank One Ohio Trust Company, N.A. v. United States of America, 80 F.3d 173 (6th Cir. 1996). See also United States v. Rye, 550 F.2d 682, 685 (1st Cir. 1977); United States v. Dallas Nat'l Bank, 152 F.2d 582, 585 (5th Cir. 1945); First Northwestern Trust Co. of South Dakota v. Internal Revenue Service, 622 F.2d 387, 390 (8th Cir. 1980); Leuschner v. First Western Bank & Trust Co., 261 F.2d 705, 707-708 (9th Cir. 1958).*

[262]*Title 11 U.S.C. §548(e).*

[263]*The only states provide unlimited cash value protection for homesteads are Iowa, Florida, Texas, Kansas, Oklahoma. However, Massachusetts does have a healthy $500,000 exemption. See this book's chapter on Exemption Planning for more information regarding homestead exemptions.*

[264]*See this book's chapter "Equity Stripping: The Good, the Bad, and the Ugly" for more on what equity stripping is and how it works.*

[265]*For example, for a self-settled trust's assets to be safe from creditors, Nevada law requires at least one trustee to be: "(a) A natural person who resides and has his domicile in this State; (b) A trust company that: (1) Is organized under federal law or under the laws of this State or another state; and (2) Maintains an office in this State for the transaction of business; or (c) A bank that: (1) Is organized under federal law or under the laws of this State or another state; (2) Maintains an office in this State for the transaction of business; and (3) Possesses and exercises trust powers." See NRS 166.015.*

[266]*See this book's chapter entitled "Asset Protection a Judge Will Respect" for more on civil contempt issues.*

[267]*Title 26 U.S.C. §509.*

[268]*See IRS form 990-PF instructions.*

[269]*See IRS publication 557, Tax Exempt Status for Your Organization. See also the article at http://www.irs.gov/charities/charitable/article/0,,id=96114,00.html for an overview of these restrictions and regulations.*

[270]*Two exceptions to this rule may be Alaska and Delaware, which allow business trusts to enjoy some limited liability. However, these trusts must conform to the statutory requirements.*

[271]*IRS Notice 97-24 (1997).*

[272]*Alsop v. Commissioner, T.C. Memo. 1999-172; Arcadia Plumbing Trust v. Commissioner, T.C. Memo. 1994-453; Brittain v. Commissioner, T.C. Memo. 1992-277. An extensive list of adverse Tax Court cases against Pure Trusts may be found at http://www.quatloos.com/taxscams/contrusts.htm.*

[273]*Ruby Mountain Trust v. Montana Department of Revenue, 2000 MT 166 (Montana Supr. Ct.), 2000.*

Chapter Thirteen

[274]*See also the IRS's primer on gift and estate taxes in IRS publication 950.*

[275]*Title 26 U.S.C. §2503(b). As of 2006, the $10,000 annual exclusion amount has been indexed to $12,000.*

[276]*Title 26 U.S.C. §2513.*

[277]*Title 26 U.S.C. §2611(c).*

[278]*Title 26 U.S.C. §§2641 and 2001.*

[279]*Title 26 U.S.C. §2642(c)(2).*

[280]*Because there are always some assets that remain outside a living trust, and because other decisions not involving trust assets may need to be made while the grantor is incapacitated, a durable power of attorney should be obtained in addition to using a living trust. Because of there relative simplicity, any estate planning attorney should be able to draft a durable power of attorney.*

[281]*The legal validity of these accounts were established as a result of the case Matter of Totten, 179 N.Y. 112 (1904).*

[282]*Clifford Crummey v. Commissioner of Internal Revenue, No. 21607 (9th Cir. 25 June 1968).*

[283]*IRS PLRs 8727003, 9045002.*

[284]*Ibid.*

[285]*In the A-B trust arrangement, the "A" trust is included in the surviving spouse's gross estate, and that spouse has rights to trust and income and may also (if the trust so allows) have the power to access trust principal. The "A" trust is often a QTIP, QDOT, or other trust that qualifies for the unlimited marital deduction (QTIPs and QDOTs are explained elsewhere in this chapter). The "B" trust is a credit shelter trust, which the surviving spouse may only receive income from, and which will not be included in his or her gross estate when he or she dies.*

[286]*In a community property state, all marital property is automatically deemed owned 50% by each spouse, unless there is a written agreement to the contrary (such as a prenuptial agreement, postnuptial agreement, or transmutation agreement.) This book's chapter on co-ownerships discusses community property ownership in greater detail.*

[287]*Title 26 U.S.C., §2518.*

[288]*Treas. Reg. §25.2518-1(b).*

[289]*Title 26 U.S.C.. §2518(b)(4).*

[290]*Title 26 U.S.C. §2056(b)(7).*

[291]*Title 26 U.S.C. §2207A.*

[292]*Title 26 U.S.C. §2056A(b)(14).*

[293]*Title 26 U.S.C. §§2056(c)(2), (a)(1).*

[294]*Title 26 U.S.C. §2056A(a)(2).*

[295]*Title 26 U.S.C. §§2056A(b)(1), (b)(2).*

[296]*Title 26 U.S.C. §2042(2).*

[297]*Activities that constitute incidents of ownership are set forth in Title 26 U.S.C. §2042(2), as well as other sections of Title 26 U.S.C., Subtitle B, Ch. 11, Subch. A, Part III.*

[298]*Title 26 U.S.C. §2035(a).*

[299]*The terms by which a QPRT qualifies as such is found in Title 26 U.S.C. §2702(a)(3).*

[300]*UFTA §4(b)(2).*

[301]*Wilferd v. Wardle, 2007 WL 391583 (D. Utah, Feb. 1, 2007).*

[302]*Title 26 U.S.C. §170(f)(2).*

[303]*Title 26 U.S.C. §664(d)(1)(A). These payments may come from the trust's principal if necessary.*

[304]*Title 26 U.S.C. §664(d)(2)(A). These payments may come from the trust's principal if necessary.*

[305]*Title 26 U.S.C. §§664(d)(1)(D), (d)(2)(D).*

[306]*Title 26 U.S.C. §§664(d)(1)(A), (d)(2)(A).*

[307]*Title 26 U.S.C. §664(c).*

[308]*Note that, in accordance with IRC §2702(a)(2)(A), the retained interest in a non-qualified trust normally has zero value and thus will not reduce the value of an asset gifted to a trust. However, qualified trusts such as the GRAT and GRUT are the exception to this rule.*

[309]*Title 26 U.S.C. §2702(b)(1).*

[310]*Rev. Rul. 77-454, 1977-2 C.B. 351.*

[311]*Treas. Regs. §25.2702-3(d)(4).*

[312]*Treas. Regs. §§25.2702-2(a)(5), 25.2702-2(d)(1) Example 6, and 25.2702-2(d)(1), Example 3.*

[313]*Treas. Regs. §25.2522(c)-3(c)(2)(vi)(t).*

[314]*Treas. Regs. §25.2702-3(b)(1)(i).*

[315]*Treas. Regs. §25.2702-3(b)(1)(i).*

[316]*Treas. Regs. §25.2702-3(b)(1)(iii).*

[317]*Treas. Regs. §25.2702-3(d)(4).*

[318]*The validity of the IDGT was verified by Rev. Rul. 85-13, 1985 C.B. 184.*

[319]*See Kove, M. and Kosakow, J.M., "The Defective Grantor Trust as an Estate-Planning Strategy," Elder Law Advisory, No. 87, July 1998, p. 2.*

[320]*Because an IDGT is a grantor trust for income tax purposes, transferring a grantor's limited partner interest into an IDGT will never trigger recognition of gain.*

Chapter Fourteen

[321]*§678(a)(2) allows a beneficiary to be the owner of a trust for income tax purposes if his withdrawal power is "partially released or otherwise modified" and the beneficiary thereafter retains a power that would normally cause a trust to be treated as a grantor trust (if the grantor had retained the same power) under §§671-677 of the IRC. In Priv. Ltr. Rul. 81-42-061 (July 21, 1981); Priv. Ltr. Rul. 85-21-060 (Feb. 26, 1985); and Priv. Ltr. Rul. 90-34-004 (Aug. 24, 1990), the IRS confirms that the lapse of a power of withdrawal is treated as a partial release of power. Therefore, after the lapse the beneficiary remains liable for trust income taxes so long as he continues to retain a power listed in IRC §§671-677.*

[322]*A DBETT may be combined with either an LLC or LP to form either an Ultimate LLC or an Ultimate LP. However, because of the similarities between LLCs and LPs, hereafter we'll only refer to Ultimate LLCs.*

[323]*For 2008, the contribution limit is $5,000 for an individual age 49 or younger, and $6,000 for someone age 50 or older. This annual contribution limit may increase in subsequent years in increments of $500 in accordance with annual inflation rates.*

[324]*Title 12 Del. Cd. §3570(11).*

[325]*IRC §679 is the primary statute that determines whether an offshore dynasty trust becomes free of U.S. income taxes (so long as it derives no U.S.-source income) once the grantor dies. This statute normally causes one or more U.S. beneficiaries to be treated as the trust's owner for income tax purposes, meaning all worldwide trust income will be paid by the beneficiaries. However, with proper planning this provision may be legally sidestepped so that U.S. beneficiaries are not liable for taxes on trust income.*

Chapter Fifteen

[326]*UFTA §1(8). Note that the UFTA's definition was derived from Title 11 USC (bankruptcy code) §§101(36),(37),(51), and (53).*

[327]*Depending on the circumstances, a lien may be perfected by recording a mortgage or deed of trust at the recorder's office in the county where the property is located (for real estate), recording a title with a lien on it at the department of motor ve-*

hicles (for vehicles), filing a UCC-1 form with your Secretary of State's office (for non-titled property), or by a court's issuance of a judgment, which can then be used to file judgment liens.

[328]*One exception is a property tax lien, which will usually take precedence over all other liens, regardless of when it arose.*

[329]*This act is found in 12 U.S.C. §1701j-3(d). An excerpt is as follows: "With respect to a real property loan secured by a lien on residential real property containing less than five dwelling units, including a lien on the stock allocated to a dwelling unit in a cooperative housing corporation, or on a residential manufactured home, a lender may not exercise its option pursuant to a due-on-sale clause upon—*

(1) the creation of a lien or other encumbrance subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property".

[330]*A disregarded entity is any entity that is ignored for tax purposes. Instead, all of the entity's activities are treated as activities of its owner. Disregarded entities include grantor trusts, single member LLCs (SMLLCs), and Disregarded Entity Multi-Member LLCs (DEMMLLCs.)*

[331]*See the UFTA §4(a)(2).*

[332]*Although §4(a)(2) of the UFTA says that a transfer is fraudulent if no exchange of reasonably equivalent value is received in exchange for the transfer, it also stipulates that a fraud-in-fact transfer must also occur (1) during or shortly before a business transaction in which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or (2) the debtor intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due. If both of these criteria are not met, then a bogus lien will not automatically be considered a fraudulent transfer, although it may still be considered fraudulent if the creditor can prove the transfer occurred "with actual intent to hinder, delay, or defraud any creditor of the debtor" (see UFTA §4(a)(1).)*

[333]*Under §1(7) of the UFTA, an insider is a relative, business partner (who has significant control or voting influence in the business), or a business entity that an individual has significant control over or voting stock in. Interestingly enough, a business partner who doesn't control the business, and a business that the individual doesn't control (at least directly) is not an insider under the UFTA.*

[334]*Occasionally a commercial lender is willing to offer a home equity line of credit up to 125% of the property's value; however these loans are often difficult to qualify for unless the applicant has an extremely high credit score. The interest payment costs remain problematic.*

[335]*See Title 11 USC §101(37). Note that this definition is in harmony with §1(8) of the UFTA.*

[336]*Structuring a loan or obligation to be of equivalent value to a lien is a critical consideration under fraudulent transfer law. See UFTA §4(a)(2).*

[337]*Although the lien is placed on the asset when the ELOC account is obtained, the lien is dormant for practical purposes unless the line of credit is used. Once creditor threat arises, the ELOC should be fully utilized, with loan proceeds being transferred out of creditor reach. We often accomplish this by using ELOC proceeds to purchase an asset of equivalent value that is unavailable, undesirable, and possibly exempt under law from creditors, such as an offshore annuity from a major foreign insurance company.*

[338]*Often those using an ELOC try to claim an income tax deduction on ELOC interest payments. Such individuals should be aware that the maximum ELOC balance towards which interest payments are deductible is $50,000 for a single individual or $100,000 for a married couple. See IRS publication 936 (2004) for more information. This publication may be accessed at http://www.irs.gov/publications/p936/ar02.html#d0e2069.*

[339]*Section 121 of the IRC allows one to sell a personal residence that has appreciated (up to $250,000 if the seller is single or $500,000 if married) without recognizing taxable gain upon sale. The seller must live in the personal residence at least two of the five years immediately preceding the sale in order to qualify for this exemption.*

Chapter Sixteen

[340]*The Anderson case is FTC v. Affordable Media LLC, 179 F.3d 1228 (9th Cir., 1999). See also In re: Lawrence, 238 B.R. 498 (Bankr. S.D. Fla. 1999), aff'd 251 B.R. 630 (S.D. Fla. 2000), aff'd 279 F. 3d 1294 (11th Cir. 2002); S.E.C. v. Bilzerian, 131 F. Supp. 2d 10 (D.D.C. 2001); and Eulich v. U.S., 94 A.F.T.R.2d 2004-5550 (N.E. Tex 2004).*

[341]*Chris Cermak, Bush: Massive measures needed against US economic collapse, Business News, 9/19/08.*

[342]*Buffett to Congress: Bail out economy or face 'meltdown', CNN.com, 9/28/08. See also Stiglitz Calls Bush Bailout Plan 'Monstrous', Zogby International, 9/26/08 ("This is only the beginning of the crisis… This [$700 billion economic bailout] plan is nothing else but a short term solution… [the bailout plan is] simply wall papering [Wall Street's problems] on to the taxpayer, and this is monstrous." – Economy Nobel Prize winner Joseph Stiglitz, in reference to the 2008 U.S. economic crisis and proposed $700 billion federal bailout plan); Paul Joseph Watson, Congressman: Stock Market Will Eventually Collapse,*

PrisonPlanet.com, 8/29/07 ("The dollar is plunging no matter what you read and hear about and no matter how hard they work to keep the bubble going the only way they can do that is by creating more money... causing the dollar to go down even faster, the market seems to be reassured - there's a contrivance to try to hold this together... but it won't last, eventually [the U.S. market is] going to collapse" – U.S. Congressman Ron Paul.)

[343]*Statement made by Dominique Strauss-Kahn at a Washington, D.C. press conference, 10/11/2008.*

[344]*Katie Benner, Robert Rubin: What Meltdown?, Fortune, 1/31/08.*

[345]*Carolyn Lochhead, Concern grows over a fiscal crisis for U.S., Chronicle Washington Bureau, 7/17/2008.*

[346]*I.O.U.S.A.'s website is www.iousathemovie.com.*

[347]*Mark Pittman and Bob Ivry, U.S. Pledges Top $7.7 Trillion to Ease Frozen Credit, Bloomberg, 11/24/2008. See also the less comprehensive but nonetheless informative article Your $3 Trillion Bailout, by David Goldman, CNNMoney.com, 10/05/08.*

[348]*Glenn Beck, Glenn Beck: The $53 Trillion Asteroid, CNN, 3/14/08.*

[349]*David M. Walker, A Call for Stewardship, The National Press Club, 12/17/07, p. 2.*

[350]*Ibid.*

[351]*William Guttmann, The Great Inflation, Gordon & Cremonesi, London, 1975, pp. 21-26.*

[352]*Costantino Bresciani-Turroni, The Economics of Inflation (English transl.). Northampton, England: Augustus Kelly Publishers, 1937, p. 335.*

[353]*Countries that have suffered hyperinflation since 1971 include Angola (1991-1995), Argentina (1975-1991), Belarus (1994-2002), Bolivia (1984-1986), Bosnia-Herzegovina (1992-1993), Brazil (1986-1994), Chile (1971-1973), Georgia (1993-1994), Israel (1971-1986), Krajina (1992-1993), Madagascar (2004-2005), Nicaragua (1987-1990), Peru (1988-1990), Poland (1990-1993), Republika Srpska (1993), Romania (1998-2005), Russia (1992-1999), Turkey (1990-2005), Ukraine (1993-1995), Yugoslavia (1989-1994), Zaire (1989-1996), Zimbabwe (1980-current (2008)). See the entry on hyperinflation at www.wikipedia.org for more on hyperinflation.*

[354]*U.S. debt as of 10/9/08, courtesy U.S. Bureau of the Public Debt.*

[355]*The authors refer to the U.S. dollar as a debt-based currency because i.e. new dollars are primarily circulated via debt purchases, such as via the Federal Reserve's overnight loans to banks, or the U.S. government's sale of T-bills to the Fed.*

[356]*Peter D. Schiff, Crash Proof: How to Profit from the Coming Economic Collapse, John Wiley & Sons, Inc., pp. 226-227.*

[357]*This assertion is based on a CNN article by Alan Silverleib (U.S. power, influence will decline in future, report says, CNN, 11/20/2008) that summarizes the National Intelligence Council report entitled Global Trends 2025: A Transformed World.*

[358]*Swiss annual inflation (average) 1993-2006 = 1.07%; Japan annual inflation (average) 1993-2006 = 0.01%.*

[359]*MSCI stands for "Morgan Stanley Capital Index". EAFE stands for "Europe, Australasia, and Far East". The MSCI EAFE index is a broad measure of world markets, excluding American markets.*

[360]*Peter D. Schiff, Crash Proof: How to Profit from the Coming Economic Collapse, John Wiley & Sons, Inc., p. 183.*

[361]*National Intelligence Council, Global Trends 2025: A Transformed World, 11/20/2008, p. iv. This article is currently available online at http://www.dni.gov/nic/PDF_2025/2025_Global_Trends_Final_Report.pdf*

[362]*Ibid, p. 29.*

[363]*Ibid, p. 30.*

[364]*Ibid., p. iv.*

[365]*Ibid., p. 8.*

[366]*Andrew Chamberlain, Corporate Income Tax Rates Around the World, The Tax Foundation, 5/5/2006. This article may be found online at http://www.taxfoundation.org/blog/show/1471.html.*

[367]*Michael Hodges, Grandfather Regulation Cost Report, Grandfather Economic Report Series, p. 1. This article may be accessed online at http://mwhodges.home.att.net/regulation_a.htm.*

[368]*Ibid.*

[369]*Lawrence J. McQuillan, Hovannes Abramyan, and Anthony P. Archie, with Jeffrey A. Johnson and Anna Erokhina, Jackpot Justice: The True Cost of America's Tort System, p. xiii. Pacific Research Institue, San Francisco, CA. 2007.*

[370]*Ibid, p. xii.*

[371]*Associated Press, Overall U.S. Trade Deficit Declined in 2007, Washington, 2/14/2008.*

[372]*Warren E. Buffett and Carol J. Loomis, America's Growing Trade Deficit Is Selling The Nation Out From Under Us. Here's*

A Way To Fix The Problem--And We Need To Do It Now, Fortune Magazine, 11/10/2003.

[373]Geoff Considine, Foreign Investing and Diversification Lessons From Berkshire Hathaway, Seekingalpha.com, 11/13/2006.

[374]See for example U.S. v. Bryce W. Townley, No. CS-02-0384-RHW (USDC E. Wash., Jul. 29, 2004). An excerpt from this case states that "Mr. Townley stated that it was his goal to protect his assets from anyone who might get a judgment against him… Plaintiff asserts that Mr. Townley's statements that he intended to protect his assets from anyone who might get a judgment against him is conclusive, direct evidence of intent to hinder, delay, or defraud. The Court agrees."

Chapter Seventeen

[375]See for example FTC v. Affordable Media LLC, 179 F.3d 1228 (9th Cir., 1999); In re: Lawrence, 238 B.R. 498 (Bankr. S.D. Fla. 1999), aff'd 251 B.R. 630 (S.D. Fla. 2000), aff'd 279 F. 3d 1294 (11th Cir. 2002).

[376]Ironically, there are eight states that allow self-settled trusts to protect assets if the trusts meet certain requirements, but OAPTs are automatically disqualified from this statutory protection. This is because each of these states requires the trustee to live in the state where the Domestic Asset Protection Trust (DAPT) law has been passed, meaning the trust must be located in that state and not offshore. This book's chapter on trusts for asset protection discusses DAPTs in greater detail.

[377]See U.S. v. Rylander, 460 U.S. 752 (1983), an excerpt of which says ""In a civil contempt proceeding such as this, of course, a defendant may assert a present inability to comply with the order in question. Maggio v. Zeitz, supra, at 75-76; Oriel v. Russell, 278 U.S. 358, 366 (1929). While the court is bound by the enforcement order, it will not be blind to evidence that compliance is now factually impossible. Where compliance is impossible, neither the moving party nor the court has any reason to proceed with the civil contempt action. It is settled, however, that in raising this defense, the defendant has a burden of production." [emphasis is ours.]

[378]United States v. Raymond Grant and Arline Grant, 2008 U.S. Dist. LEXIS 51332, U.S. District Ct., S.D. Florida, May 27, 2008

[379]U.S. v. Raymond Grant and Arline Grant S.D.Fla. (W.Palm Case No. 00-CV-8986), 2005.

[380]See Title 26 U.S.C. §1441(a).

[381]This is accomplished by filing IRS form 8832.

[382]In the case of a natural person, the LLC's income would be reported on the owner's 1040 schedule C return.

[383]FTC v. Affordable Media, LLC, 179 F.3d 1228 (9th Cir. 1999.)

[384]A self-settled trust is a trust wherein the grantor is also a trust beneficiary. Currently, 46 of the 50 states have some sort of statute that specifies that, to the extent a grantor is also a beneficiary, his beneficial interest shall be freely attachable by creditors. This usually means a creditor may also directly invade the trust's corpus (property), spendthrift provision notwithstanding.

Chapter Eighteen

[385]In re Turner, 335 B.R. 140 (Bkrpt. N.D. Cal 2005).

[386]A spendthrift clause prohibits a creditor of a beneficiary from attaching trust assets so long as they remain undistributed. An example of statutory protection of spendthrift trusts is Texas Property Code §112.035(b).

[387]Albert Strangi v. CIR, 417 F.3d 468 (5th Cir. 07/15/2005).

[388]Some statutes, including the LLC Acts of several states, do not require a business entity to have a business purpose. For example, §53-19-6 of the New Mexico LLC Act allows LLCs to be formed for "any lawful business or purpose." [emphasis is mine] However, because New Mexico courts have not yet ruled on this matter, and New Mexico LLCs might be subject to litigation in other, more restrictive states, it's safest to use LLCs for only legitimate business endeavors.

[389]U.S. v. Bryce W. Townley, No. CS-02-0384-RHW (USDC E. Wash., Jul. 29, 2004).

[390]The general rule is that domestic entities that are disregarded for tax purposes need file no informational or other return. Offshore entities, however, always file some sort of return if their owner is a U.S. person. Note, however, that these returns may be simpler than the return filed by an offshore entity that is not disregarded from its owner(s) for tax purposes, e.g. an IRS 5471 (offshore corporation) or 8865 return versus the simpler 8858 disregarded entity return.

[391]A judge asked this same question in Brown v. Higashi No. A95-00200-DMD (Fed.B. Alaska 03/11/1996).

[392]FTC v. Affordable Media LLC, 179 F.3d 1228 (9th Cir., 1999); In re: Lawrence, 238 B.R. 498 (Bankr. S.D. Fla. 1999), aff'd 251 B.R. 630 (S.D. Fla. 2000), aff'd 279 F. 3d 1294 (11th Cir. 2002).

[393]Ibid.

[394]*U.S. v. Rylander, 460 U.S. 752 (1983).*

[395]*See footnote 8, above.*

[396]*A particularly egregious example of this is JSC Foreign Economic Assoc. Tech v. Int'l Development and Trade Services, Inc., 306 Supp. 2d 482 (S.D.N.Y., 2004).*

[397]*United States v. Raymond Grant and Arline Grant, 2008 U.S. Dist. LEXIS 51332, U.S. District Ct., S.D. Florida, May 27, 2008*

[398]*For an example of asset protection combined with bankruptcy fraud, see In re: Stephen J. Lawrence 227 B.R. 907 (Bkrtcy. S.D.Fla. 09/23/1998). A particularly notable excerpt of this case says, "The hearing continued over a three (3) day period during which this Court had a unique opportunity to observe the Debtor… This Court endured eleven hours of what can candidly only be described as disingenuous and untruthful testimony from the Debtor. It seems clear that over the course of the Debtor's testimony he committed perjury on several occasions. Such conduct serves only to undermine not only the discovery process but also the integrity of the judicial system and the Bankruptcy Code. The Debtor voluntarily sought the protection of the Bankruptcy Code, yet seems unwilling to play by the rules and offer up full financial disclosure. Even after numerous admonishments, the Debtor chose not to testify truthfully."*

[399]*An excellent overview of the improper use doctrine as it relates to veil-piercing of a limited liability entity is found in Garcia v. Coffman, 124 N.M. 12, 946 P.2d 216 (N.M.App. 1997).*

[400]*In re: Ashley Albright, No. 01-11367 (Bkrptc.D.Col. 04/04/2003).*

[401]*Ibid.*

[402]*Crocker National Bank v. Perroton, (208 Cal. App. 3d 1, 1989).*

[403]*Hellman v. Anderson, (233 Cal. App. 3d 840, 1991).*

[404]*Note that this observation was also made by the Colorado District Bankruptcy Court in the In re: Ashley Albright case. See chapter 10 for more information.*

[405]*In re: Ehmann (2005 WL 78921 (Bankr. D. Ariz. 2005).*

[406]*For the purposes of this chapter, we will hereafter consider LLCs and LPs as one and the same, unless otherwise noted.*

[407]*'Reverse Piercing' is where the creditor of a company's owner is allowed to reach company assets for the owner's debt. This is the same situation in which charging order protection would prevent company assets and/or control from falling into the hands of an owner's creditor.*

[408]*LFC Marketing Group, Inc. v. Cebe W. Loomis, 116 Nev. 896; 8 P.3d 841 (Nev. S.C., 2000).*

[409]*Floyd v. I.R.S., 151 F.3d 1295, 1300 (10th Cir. 1998).*

[410]*See IRS Rev. Rul. 2004-77, which demonstrates it is possible to structure a multi-member LLC that is disregarded from its owner for tax purposes.*

Chapter Nineteen

[411]*For information on how an offshore management company might be structured, see this book's chapter on offshore planning.*

[412]*The concept of community property is discussed in chapter 7 of this book.*

[413]*UFTA §4(a).*

Chapter Twenty

[414]*Ca. Civil Code §3439.09(c).*

[415]*See the chapter in this book entitled "Using the Charging Order, Pass-Through Taxation, and Phantom Income to Lay a Tax Trap for Creditors" along with the chapter on limited partnerships for more information on COPEs.*

[416]*See the chapter in this book entitled "Using the Charging Order, Pass-Through Taxation, and Phantom Income to Lay a Tax Trap for Creditors" as well as IRS Rev. Rul. 77-137 for more information on why the Trojan Horse Strategy is feasible.*

[417]*Ideally, the 3rd party manager should not be an "insider" of the client per the U.F.T.A. See §§1(1) and 1(7) of the U.F.T.A. for its definition of an insider.*

[418]*The plan should also be implemented under an attorney's supervision, so that attorney/client privilege attaches to the entire arrangement.*

[419]See the author's article Multi-Stage Equity Stripping: The Solution to Traditional Equity-Stripping Shortcomings for more information on multi-stage equity stripping.

Chapter Twenty-One

[420]Names have been changed.

[421]Cummings v. Missouri, 71 U.S. (4 Wall.) 277, 323 (1867); cf. United States v. Brown, 381 U.S. 437, 441 -442, (1965).

[422]U.S. Constitution, Article I, Section 9, Clause 3; Article 1, Section 10, Clause 1.

[423]Springer v. U S, 102 U.S. 586 (1880).

[424]An example of IRS procedure that allows for protection of assets against the IRS can be found in IRS ILM 199930013 (1999), which states that the IRS cannot collect LLC assets to satisfy the tax debt of its owner, even if the LLC is owned by only one person and thus disregarded for tax purposes.

[425]Flora v. United States 357 U.S. 63 (1958), aff'd on reh'g, 362 U.S. 145 (1960).

[426]Lord v. Kelley, 240 F. Supp. 167 at 169 (1965). Judge Wyzanski in this case commented, "More than once, the judges of a court have been indirectly reminded that they personally are taxpayers. No sophisticated person is unaware that even in this very Commonwealth, the Internal Revenue Service has been in possession of facts with respect to public officials which it has presented or shelved in order to serve what can only be called political ends, be they high or low. And a judge who knows the score is aware that every time his decisions offend the Internal Revenue Service, he is inviting a close inspection of his own returns."

[427]Article III courts are courts set up under Article III of the Constitution, which governs the judicial branch. The U.S. Tax court is set up by the legislative branch, and is therefore governed by Article I of the Constitution, often being referred to as an "Article I Court" or Tribunal. Article I Courts have several restrictions on their enforcement and adjudication powers.

[428]Note, for example, 28 U.S.C. §3003(b) of The Federal Debt Collection Procedure (Title 28 U.S.C., Chapter 176) allows the IRS to circumvent state and other exemptions that are otherwise extended to provide protection against other federal government agencies.

[429]Texas Property Code §42.001(b)(1).

[430]Texas Property Code §41.001.

[431]See 29 U.S.C. § 1056(d)(1).

[432]An example of ERISA protected pensions not protected by ERISA's anti-alienation provision from IRS attachment can be found in U.S. v. Taylor, 338 F.3d 947 (8th Cir. No. 01-2874, July 31, 2003) and IRS v. Snyder, 343 F.3d 1171 (9th Cir. Appeal No. 02-15618, September 15, 2003).

[433]Title 26 U.S.C. §6502.

[434]Ibid.

[435]Beefing Up the IRS with Outside Help, p.1, by Charles Silver (Drum Major Institute for Public Policy, 2006.) This article can be accessed online at http://www.tortdeform.com/archives/2006/09/beefing_up_the_irs_with_outsid_2.html.

[436]See IRS ILM 199930013 (1999).

[435]See Title 26 U.S.C.§6323(a), (f).

[438]See Title 26 U.S.C.§6323(c).

[439]Common law as well as the applicable statutes in most states do not allow for a self-settled trust to protect a grantor's assets, to the extent the grantor is also a beneficiary of the trust. For example, see Texas Property Code

[440]§112.035(d), which states, "If the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of his beneficial interest does not prevent his creditors from satisfying claims from his interest in the trust estate." However, non-self settled spendtrhift trusts will provide asset protection as long as fraudulent transfers are not an issue. See, for example, Texas Property Code §112.035(a). Certain offshore jurisdictions do allow asset protection for self-settled trusts, however.

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Mr. Fowler originally began researching asset protection in an attempt to rectify the many differences of opinion, both within and without professional circles, as to which asset protection strategies worked and which didn't. In order to separate fact from hype, Mr. Fowler would only support a strategy if he could prove its efficacy via a thorough analysis of statutory law, case law, and other relevant facts. The results of this research has made Mr. Fowler a pioneer in some of the most advanced asset protection strategies available, such as equity stripping via obligation based liens, UFTA §8(a) defense strategies, and the use of disregarded entity multi-member LLCs (DEMMLLCs). The culmination of his research is found in this book, which is Mr. Fowler's 2nd book on wealth preservation, and which is co-authored with Dr. Arnold S. Goldstein, PhD, JD, LLM, MBA. Mr. Fowler currently resides in Salt Lake City, Utah.

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THE ONLY BOOK ABOUT PROTECTING YOUR WEALTH AGAINST ALL THREATS, NOT JUST LAWSUITS

People spend thousands to protect their wealth against lawsuits, only to then lose their wealth to a 50% (or higher) estate tax, divorce, or market meltdown. In today's high-tax, perilous economic times, an asset protection plan is no longer enough. We must plan in a broader holistic wealth preservation context.

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Asset Protection is written for both professionals and their clients. Professionals will find this book a valuable resource to enhance their practice. Clients will be able to separate the facts from the hype and many differences of opinion as to what works and why, so they can make sure the plan they choose, and the professional they choose to implement it, is the best one for their circumstances.

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