



Asset Protection

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Many investors have had more than enough first-hand experience lately with investment risk of all shapes and sizes—systemic risk, valuation risk, market risk, credit risk—the list goes on. As a result of exposure to these risks, many portfolios are down 20–40 percent from their 2007 highs, and many clients are shocked and surprised at this significant loss of wealth.

Their reaction can be explained by a human behavioral phenomenon known as optimism bias. Optimism bias is the demonstrated systematic tendency for people to be overly optimistic about the outcome of planned actions. This includes overestimating the likelihood of positive events and underestimating the likelihood of negative events (see http://en.wikipedia.org/wiki/optimism_bias).

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Many of your clients have just experienced a major investment risk-reality check, which makes this a good time to shake off what remains of optimism bias and address other risks to their wealth. What follows is a brief discussion of some of the most common risks to wealth and some of the tools available to us to help protect our clients from them.

Creditor Risk

Creditor risk is the risk a creditor may prevail in a legal action stemming from such events as a car accident with bodily injury, a malpractice suit, or a divorce. It is perhaps the most common threat to client wealth. As one wealth protection strategist claims, “Your odds

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of being sued are greater than your odds of being in the hospital!” (Bronchick 2009). And the wealthy are even more likely to become targets.

The most basic way to address creditor risk is through insurance—umbrella policies, professional liability coverage, etc. A good start is to make sure your client’s coverage is complete, in-force, and adequate. A thorough risk assessment combined with a property and casualty insurance portfolio review will help reveal any gaps in coverage.

The next thing to consider is that some assets are protected from creditors automatically. The list of protected assets varies from state to state, but most states exempt the homestead (up to a certain limit), retirement plans,¹ annuities, and insurance benefits. Many of these exemptions are ridiculously low. For instance, the real estate and personal property exemption in Indiana is \$15,000 (<http://www.in.gov/legislative/ic/code/title34/ar55/ch10.html>). Some states allow for ownership of property as tenants by the entirety, which is a form of ownership between spouses that provides significant asset protection. This form of ownership should be taken advantage of whenever available.

For clients with higher net worth, even the most comprehensive insurance plan and maximum funding of exempt asset categories will not provide

adequate protection. For greater protection, we turn to trusts and other entities such as family limited partnerships (FLPs) or family limited liability companies (FLLCs).

Protecting Your Client’s Assets from Creditors

You may find that some of your clients are using a kind of “do-it-yourself” method of asset protection by transferring assets to their spouses as separate property. For instance, if one spouse is active in a high-risk business that is naturally subject to creditor claims, that spouse could systematically transfer excess assets to the other less-vulnerable spouse. This strategy is subject to multiple risks such as: exposing the transferor to claims of fraudulent transfer, not providing protection from the less vulnerable spouse’s creditors, and the transferor losing control of and claim to the transferred assets in the event of death or divorce. Thus, it is wise to consider some of the other asset protection methods suggested here.

DAPT. One way to help protect your client’s assets from future creditors is through the use of a domestic asset protection trust (DAPT) or foreign asset protection trust (FAPT). These types of trusts are also known as “self-settled trusts” because they are established for the benefit of the person who creates

and funds them. In other words, the settlor is also the beneficiary. Such trusts may be established in domestic or foreign jurisdictions. Currently, only 13 states in the United States allow self-settled trusts.² If your client isn't a resident of a state with a DAPT statute, he/she still can create a trust governed by the laws of a state that does have one. For instance, Delaware has a DAPT statute. As a resident of Indiana, your client can create a Delaware Self-Settled Trust and take advantage of Delaware's DAPT statute. The primary requirements are that the client creates an irrevocable trust that 1) contains a spendthrift clause; 2) provides that Delaware law governs the trust's validity, construction, and administration; and 3) appoints at least one Delaware trustee.³

A DAPT is best funded with excess assets. In other words, your client should keep enough assets outside the DAPT to cover living needs and the claims of existing and foreseeable creditors. Your client cannot receive a distribution whenever he/she pleases and should not request assets from the DAPT on a regular basis, so you need to be careful not to overfund the trust. Trust provisions can provide for income or unitrust distributions; however, this may not be desirable because anything distributed no longer will be afforded creditor protection. Provisions in the trust can provide for future distributions; however, such provisions may compromise the protection of assets remaining in the trust.

A DAPT is best funded well before any claims of creditors arise. You should work with your client to determine whether claims of creditors are existing, probable, possible, or remote. A fraudulent transfer occurs when a debtor transfers assets without adequate remuneration and prevents a creditor from collecting on the debt. Most states have a four-year statute of limitations with respect to fraudulent transfers. In addition, the U.S. Bankruptcy Code requires a 10-year look-back period if there is

actual intent to defraud. As a general rule of thumb, you should not put more than 40 percent of your client's total net worth into a DAPT. Ideally, asset protection planning should be accomplished as part of an overall estate or business planning process. Thus, the planning will include goals unrelated to asset protection. This will provide good evidence that transfers were not made with the intent to defraud creditors.

It is important to note, there has not yet been a court case testing whether a DAPT statute will hold up under challenge—either for a resident or nonresident settlor. One likely reason is that most cases are settled out of court.

Nonresident settlors may find conflict between the laws of the DAPT state and their home states. Some practitioners believe that the home-state laws or even federal laws may prevail, in which

likely to apply Delaware law as opposed to the law of the state of residency of the settlor (Merric 2009). Uncertainties aside, a DAPT creates some troublesome obstacles that creditors must overcome before they are able to reach your client's assets. Thus, under the right circumstances, it is a strategy worth considering.

FAPT. Use of an FAPT or offshore trust may provide enhanced creditor protection. The tradeoff for this added protection is higher costs, decreased access to assets, less control, and exposure to the risks inherent in foreign jurisdictions. An FAPT must be created and funded at the right time and under the right circumstances (Gopman 2009). Just as with a DAPT, the right time is before there are any identifiable or foreseeable creditor claims. If claims are looming or exist at the time the

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case the DAPT may be invaded to satisfy creditors. However, the Delaware statutes, for instance, state explicitly that any claims must be brought in Delaware and the Delaware Court of Chancery is diligent in its application of the statute.

In addition, there are ways to increase the odds of success. It stands to reason that the fewer connections the trust has to the nonresident settlor's state and the more connections it has to the DAPT state, the more likely it is that the laws of the DAPT state will prevail. For instance, if the governing law is Delaware's, the trust is administered in Delaware, the sole trustee is in Delaware, and all the assets are in Delaware, then a court may be more

planning is executed, your client may risk incarceration by moving assets offshore. The right circumstances involve engaging reputable advisors, trustees, and institutions to assist with design and implementation.

Finally, use of an FAPT should not be viewed as a tax-saving strategy. As long as your client is a U.S. citizen, federal tax will be assessed on the income from assets transferred to an FAPT. You also should be aware that disclosure requirements for foreign-held assets are more stringent than in the past (IRS Oversight Board 2009). Thus, your client's tax preparer should be aware of and prepared to fulfill the many compliance requirements of foreign investments (Merk and Harrison 2009).



If a DAPT or an FAPT seems too restrictive or “irrevocable” to your client, consider other possibilities. For instance, under certain circumstances, the use of an FLP or FLLC and general appointment trust combination might be appropriate. Such an arrangement would provide a basic level of asset protection but still contain revocable features.

Protecting Assets Gifted or Bequeathed to a Beneficiary from the Beneficiary’s Creditors

Trusts. Trusts are created for a multitude of reasons, one of which may be creditor protection. However, when it comes to creditor protection, not all trusts are created equal. The particular provisions of a trust will determine how safe the assets are from creditor claims. At a minimum, the trust should include a spendthrift provision that prevents the beneficiary from selling or borrowing against the assets of the trust (Sandoval 2003). A trust in which the trustee has the sole and absolute discretion to decide on the amount and timing of income and principal distributions to the beneficiary affords greater protection than one that has mandatory distribution requirements (Kanyuk 2007). A support trust, i.e., one that instructs the trustee to make distributions to the beneficiary for his or her support, falls somewhere in the middle as far as protection goes. Another important factor to consider is how much control the beneficiary has over his or her interest in the trust. For instance, if the beneficiary has the power to appoint assets to creditors at his or her death, this might expose the assets to creditors during life as well. Just as with self-settled trusts, the laws of the jurisdiction governing the trust will have bearing on how much creditor protection the trust can provide. States that have adopted the Uniform Trust Code generally provide less protection than those that have not. This is because the Uniform Trust Code expands creditor’s rights in many areas.

FLP or FLLC. The family limited partnership (FLP) or family limited liability company (FLLC)⁴ is a common estate-planning tool that happens to be a good asset protection tool as well. Assets held in such entities are less attractive and less valuable to creditors than assets held outright. Just as with trusts, the treatment of creditors varies from state to state. At issue is whether a creditor can force distributions of assets from the entity or seize an interest in the entity and sell it. In some states, the creditor is treated as a mere assignee, the lowliest of creatures in the debtor/

partnership agreement may help as well, such as giving the entity or other owners the right to purchase the interest of the debtor partner over a period of years at a favorable interest rate and providing for a quick, simple, and favorable method of valuation (Mata 2007). A single-member limited liability company (LLC) is not as protective as a multiple-member LLC.

Generally, FLLCs protect both controlling and noncontrolling members. In some states use of an FLP is preferred over an FLLC due to nuances in the law. However, with an FLP, the

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creditor world. Mere assignees must lurk and await distributions, all the while paying tax on the flow-through income of the entity, and the general partner may be able to delay distributions indefinitely. Often the mere assignee gives up and goes away or settles for cents on the dollar. At the other end of the spectrum are the states that allow judicial foreclosure in which the court forces a fire sale of the entity interest to a speculative investor, usually at a fraction of its underlying value (Merric and Comer 2007). Thus, when asset protection is paramount, set up the FLLC under the laws of a jurisdiction that favors the settlor over the creditor, an activity known as forum shopping.⁵

Various strategies may improve asset protection planning with FLLCs. For instance, by gifting FLLC interests to trusts as opposed to outright, your client creates two hurdles for potential creditors. Certain language in the

general partner has personal liability. To avoid this personal liability an LLC may be created to fill the general partner role.

Divorce

Most of us are aware that 40–50 percent of marriages end in divorce (Hurley 2009). Even if you escape the statistic yourself, one of your close family members likely will experience a divorce. Divorce represents the second most-common risk to an individual’s wealth. Divorce leads to a 77-percent loss of wealth for the average divorcing individual and is one of the fastest ways to destroy wealth (Zagorsky 2005).

One of the most reliable ways to protect your client’s family wealth from a divorce is a well-drafted premarital (a/k/a prenuptial) agreement that is properly executed well in advance of the wedding. The following are key factors that determine whether a premarital

agreement will be enforceable and effective:

- The agreement must not be a product of fraud, duress, mistake, misrepresentation, or nondisclosure of material fact (Wolven 2004).
- The agreement needs to be fair and reasonable. A fair premarital agreement takes into account the length of the marriage and the involvement of both spouses in wealth production. It does not necessarily create two equal partners in terms of wealth, but it doesn't leave one party economically uncomfortable if the other has more than enough (Baskies 2000).
- Both the husband and the wife should have separate legal representation.
- All assets and liabilities of both parties must be disclosed.

Despite the proven effectiveness of premarital agreements, it is difficult to convince clients to raise the subject with family members, let alone insist on them. People may think that such agreements are contrary to social or religious customs, or they may feel such agreements cast doubt upon the relationship (Sildon 2006). The full-disclosure requirement may spark reluctance. For whatever reason, if a premarital agreement is inappropriate, all is not lost.

Generally, any property owned by a spouse before marriage or acquired as a gift or bequest during marriage is considered separate property. All else is marital property and subject to claims of the spouse. Care should be given not to comingle separate property with marital property. Separate property can be inadvertently converted into marital property.

One important concept to grasp is the difference between a community-property state and an equitable-distribution state. Most states are equitable-distribution (or common-law) states. Property acquired during a marriage typically belongs to the person who earned it or in whose name it is titled. Upon divorce, this marital property is subject to division by the courts in

an equitable manner. In community-property states, all property acquired during marriage is deemed community property, i.e., owned 50–50 between the spouses.⁶ A judge, however, may determine a different ratio.

As long as inherited, gifted, or other property that is brought into the marriage is kept separate, it will not become a marital asset. As a practical matter, however, it's difficult to keep separate assets separate. Life happens. Funds may be comingled inadvertently, or a couple living in an equitable-distribution state may move to a community-property state, thus converting what may have been separate property to marital property. In some circumstances, separate assets may be inadvertently converted to marital assets when marital assets are used to pay taxes generated by the separate assets.

Titling is important and may help keep separate assets separate, but your client may desire more certainty. Many of the measures that protect assets from creditors also are effective at protecting assets during a divorce. Trusts and LLCs are effective ways to keep assets segregated and limit accessibility to a spouse.

A trust created before marriage is unlikely to be considered part of the marital estate of the beneficiary unless the beneficiary is also a trustee or he/she retains too much control over the assets of the trust. Even a trust created after marriage may protect assets from a divorcing spouse. The less control the beneficiary retains, the more likely the trust assets will be considered separate assets.

The specific terms of a trust will determine whether distributed or undistributed income will be considered separate property. For instance:

- Income distributed from a trust created by a third party is likely to be considered separate property as long as it is not comingled with marital property (Mata 2007).
- Undistributed income from a trust

in which the beneficiary has an absolute right to receive the income likely will be marital or community property (Mata 2007).

A DAPT set up in the right jurisdiction can protect assets from a soon-to-be spouse. In fact, use of an asset protection trust in lieu of a premarital agreement seems to be gaining popularity. Nevada's statute purports to allow an individual to create a DAPT after marriage and protect the assets from a divorcing spouse (Nenno 2009). Other factors should be considered, however, before selecting Nevada as a jurisdiction for post-marital planning.

Assets transferred to a partnership (including an FLP or LLC) before marriage are protected as separate property. However, income earned by the partnership and distributed to the partner likely will become marital or community property and exposed to the claims of a divorcing spouse. Undistributed partnership income should be protected, but make sure the partnership makes distributions to cover taxes incurred as a result of partnership income (Mata 2007).

If a divorcing spouse receives an interest in an FLP under the terms of a divorce, the partnership agreement typically will treat him/her as a mere assignee. As discussed above, this lowly status likely will motivate the spouse to relinquish his/her interest as quickly as possible.

Special consideration should be given to protecting an operating family business during a divorce. Terms can be included in a premarital agreement that require a former spouse to sell any family business stock acquired during marriage back to the family at fair market value. The pre-marital agreement also can require the former spouse to forfeit any voting or management rights (Sildon 2006).

A buy-sell agreement can be used to control what happens to family business stock in the event of a divorce. The agreement can specify if the shares are




automatically redeemed or are callable at the option of the company, dictate a time frame for such occurrences, and establish a method for valuing the shares.

Asset Protection Planning: Key Considerations

Asset protection plans often involve moving assets to trusts or other entities and jurisdictions that restrict a creditor's access to those assets to settle a claim.

- Timing is everything. Don't wait for a creditor claim to arise before implementing an asset protection plan for your client. If you do, the plan may be unraveled in court and you and your client may have committed a fraudulent or preferential transfer (Cornell University Law School 2009).
- The general rule is that the more control and access relinquished, the more creditor protection afforded.
- The specific provisions of a trust or circumstances surrounding the funding and administration of an FLLC will determine how effective these entities are at protection from creditors.
- A fair, well-drafted premarital agreement executed in advance of the wedding is a good way to provide protection in the event of divorce.
- Trusts and FLLCs can be effective at keeping separate assets segregated from marital assets.

While wealth accumulation has been the battle cry of the past few decades, recent economic and political circumstances are making wealth preservation a higher priority for many individuals and their advisors. Protecting your client's wealth from creditors and divorce is the first step to wealth preservation. 

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Endnotes

- ¹ Generally, inherited individual retirement accounts (IRAs) are not exempt and protection for IRAs of more than \$1 million may be subject to limitations in certain states.
- ² The following states allow self-settled trusts: Alaska, Colorado, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Oklahoma, South Dakota, Tennessee, Rhode Island, Utah, and Wyoming.
- ³ Delaware Statute 12 Del. C. §3570.
- ⁴ For purposes of this article, FLP will be used synonymously with FLLC.
- ⁵ States such as Alaska, Delaware, South Dakota, Texas, Virginia, New Jersey, and Florida provide enhanced asset protection. Offshore entities may provide even greater protection.
- ⁶ Community property states include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

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