



Domestic and International Asset Protection Planning

Corpus Christi Estate Planning Council

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Who Should Engage in Asset Protection Planning?

- Asset protection planning is inherent in all estate planning
- Every client needs asset protection to some degree; although some clients are more at risk:
 - High-risk professions (doctor, lawyer, accountant, investment advisor)
 - High-risk corporate capacities (director/officer of public company)
 - High-risk business endeavors (manufacturing items that could cause harm)
 - High-profile positions (entertainer, sports figure, politician)
 - Risky hobbies (recreational pilot, into fast cars/motorcycles)

The U.S. Legal System is Creditor-Friendly

- Plaintiffs don't have any skin in the game
 - Contingency fees
 - No bond requirement, except in appeals
 - No loser-pay system
- Punitive damages are allowed in civil actions against individuals, not just against large corporations
- Parties in judicial proceedings receive privilege and freedom from civil liability for libel in pleadings, absent a finding of actual malice.

Is Asset Protection Planning Against Public Policy?

“We . . . admit that there is a just and sound policy . . . to protect creditors against frauds upon their rights **But the doctrine, that the owner of property, in the free exercise of his will in disposing of it, cannot dispose of it, but that the object of his bounty . . . must hold it subject to the debts due his creditors . . . is one which we are not prepared to announce as the doctrine of this court.**”

“[E]very State in this Union has passed statutes by which a part of the property of the debtor is exempt from seizure [for] the payment of his debts. . . . **To property so exempted the creditor has no right to look** . . . as a means of payment when his debt is created [and] this court has steadily held that [such exemptions are] invalid as to debts then in existence [but] as to contracts made thereafter, the exemptions [are] valid. This distinction is well founded in the sound and unanswerable reason, that the creditor is neither defrauded nor injured by the application of the law to his case, as he knows, when he parts with the consideration of his debt, that the property so exempt can never be made liable to its payment.”

Nichols v. Eaton, 91 U.S. 716, 725–726 (1875).

Creditor Protection: Fraudulent Transfers

- **General rule**
 - A gratuitous (or mostly gratuitous) transfer of property with the actual or constructive intent to avoid creditors may be set aside
- **Classes of creditors & what they must prove**
 - Present creditors (more protected)
 - Constructive intent: gratuitous transfer + insolvency
 - Future creditors (less protected)
 - Actual intent: proven with badges of fraud; or
 - Gratuitous transfer + intended to incur debts beyond ability to pay or was about to engage in a transaction for which remaining assets unreasonably small in relation to the transaction
- If fraudulent as to “any creditor,” transfer will be void

Creditor Protection: Fraudulent Transfers (cont'd.)

- **Statute of limitations**
 - State Law: Statute of limitations on fraudulent transfer claims in most states is four years, or, if later, within one year of when the transfer could reasonably have been discovered
 - Bankruptcy Law: A bankruptcy trustee can have a fraudulent transfer set aside if the transfer is made within two years of bankruptcy; certain transfers to a self-settled trust or similar device subject to a ten-year statute of limitations
- A transfer of assets from non-exempt status to exempt status should be tested for fraudulent transfer

Preventing a Fraudulent Transfer: Solvency Test

Total value of assets

Less: Liabilities (including contingent)

Less: Creditor-protected assets (e.g., homestead)

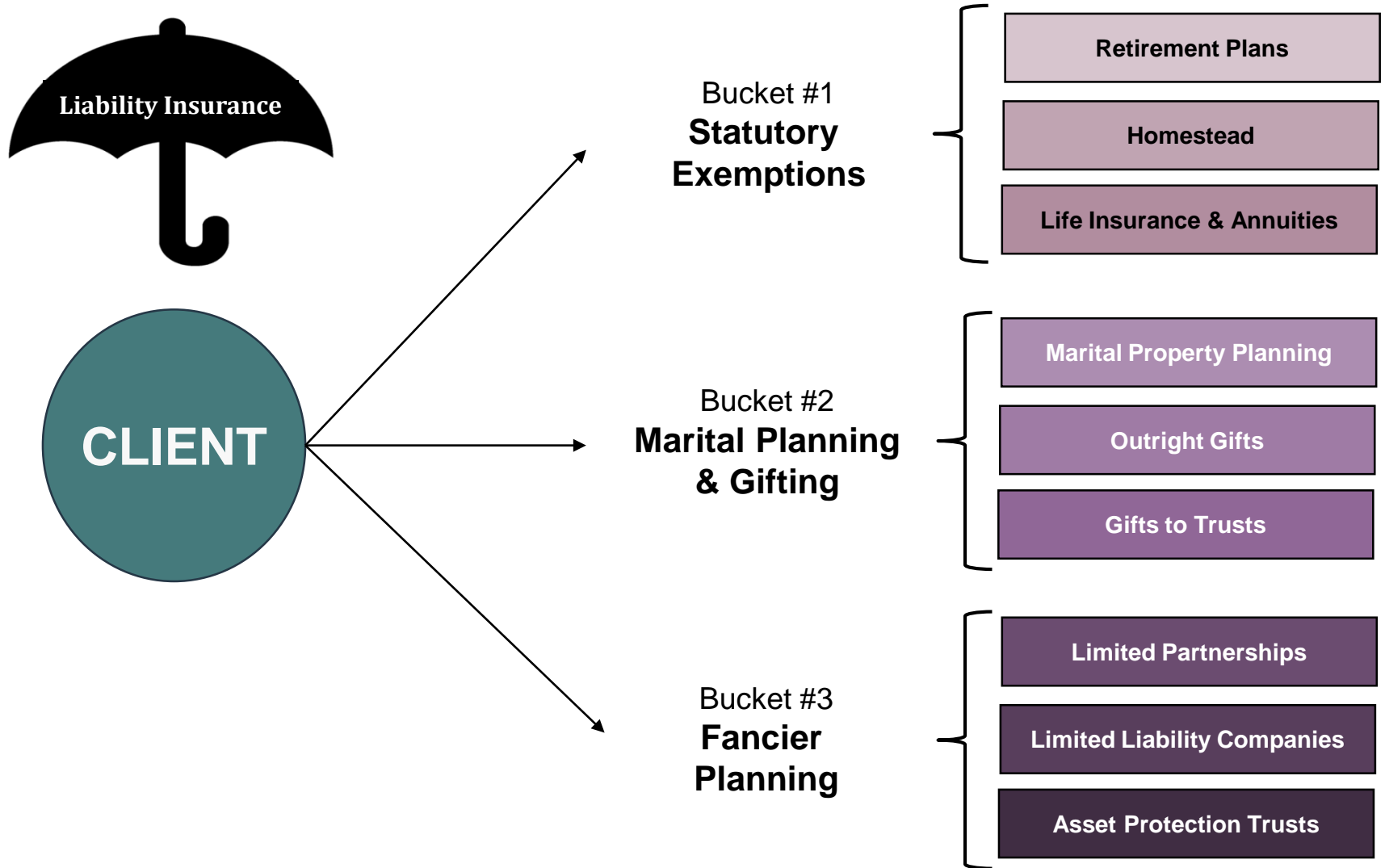
Equals: Amount that can be transferred

Asset Protection Planning—a Process

- Determine whether the client is able to fully insure against foreseeable business and personal risks
- Fill the available “buckets”

You will find that the greater the client’s net worth, the more difficult it is to achieve asset protection without a protective trust structure because the traditional protected buckets quickly fill to overflowing

Asset Protection Planning—a Process



Retirement Plans

- In most states, unlimited exemption as long as the plan “qualifies” under the Internal Revenue Code
- ERISA contains anti-alienation provisions
- Inherited IRAs may or may not be protected under state law
- Bankruptcy
 - Fully protected if exempt from taxation under IRC §§ 401, 403, 414, 457, or 501(a)
 - Protection for IRAs (under IRC §§ 408 and 408A) capped at \$1,000,000, adjusted for inflation (currently, \$1,283,025)
 - Rollover amounts to IRAs are excluded from cap

Homestead

- State homestead exemptions based upon either acreage (e.g., Florida, Texas, and Kansas) or value (e.g., California and Missouri)
- Bankruptcy law limits equity obtained in homestead during ~40 months (1,215 days) prior to bankruptcy to \$125,000, adjusted for inflation (currently, \$160,375)

Life Insurance and Annuities

- Many states exempt cash value and policy proceeds of life insurance and annuities
 - There is much variation among state statutes, depending on the identity of the insured, the beneficiary, the owner, etc.
- In some states, this exemption extends to policy proceeds in the hands of the beneficiary and protects those proceeds from the beneficiary's creditors as well
- In bankruptcy, exemption is limited to payments on the life of an individual of whom the debtor was a dependent, and only to the extent reasonably necessary for the support of the debtor and the debtor's dependents

Marital Property Planning

- **Third-party creditors**
 - Property can be divided so that the exposed spouse owns exempt assets and unexposed spouse owns non-exempt assets
- **Spouse/Steps as creditors**
 - Marital property agreements clearly define property rights and protect spouses from each other upon divorce
 - In blended families, step-parent and step-children are protected from each other
- Partition agreements: beware of losing basis step-up on surviving spouse's half of the community
- Tenancy by the Entirety available in about half the states

Gifting

- **Outright gifts**

- Annual-exclusion gifts to family members
- Direct payment of medical bills
- Direct payment of tuition
- Gifts to charities

- **Gifts to spendthrift trusts**

- Trusts for Descendants
- Trusts for Spouse

Gifts to Spendthrift Trusts

- A spendthrift trust is one in which the beneficiary is precluded from voluntary or involuntary transfers of trust assets
- The consequence of a spendthrift provision in a trust document is that the beneficiary's creditors cannot reach trust assets to satisfy a claim
- In most states, settlors cannot utilize a spendthrift trust to protect assets from the settlor's own creditors

Limited Partnerships and Limited Liability Companies

- **Aggregate Theory of Partnership (historical view)**
 - The partnership is not a distinct legal entity separate from the partners
 - Each partner owns an undivided interest in partnership property, making turnover of assets to creditors without impact on non-debtor partners impossible
 - Charging order as a remedy protected both the creditor and the non-debtor partners
 - LLC statutes were modeled on partnership statutes, and so they adopted the partnership statutes' charging order provisions

Limited Partnerships and Limited Liability Companies (cont'd.)

- **Entity Theory of Partnership (current view)**
 - The partnership is a distinct legal entity separate from its partners
 - Partners do not own an interest in partnership property; instead, they own an interest in the entity as personal property
 - Under the entity theory, there is no real distinction between partnerships, LLCs, and corporations; thus, it is difficult to argue that charging order laws are needed to protect the other partners
 - Under the entity theory, the only thing standing in the way of a creditor's ability to divest a partner of his interest in the entity is the applicable state statute
- It is interesting to note that Nevada has passed a charging order statute applicable to privately held corporations (NRS § 78.746)

Charging Order

- An order issued by a court which charges the debtor's interest in the entity with the amount due to the judgment creditor
- The creditor only gets distributions from the entity to the extent of the debt (and only if the GP/Manager issues distributions)
- Once the debt is extinguished, the charging order is fulfilled; the debtor's interest in the underlying company assets is preserved

Foreclosure

- Some state statutes provide that a charging order is a “lien” on the debtor’s interest in the entity that can be foreclosed upon
- If this happens, the debtor loses his interest in the entity and all of the future benefit of that interest forever (even if that benefit greatly exceeds the debt), including a right to a pro rata share of any new assets at liquidation

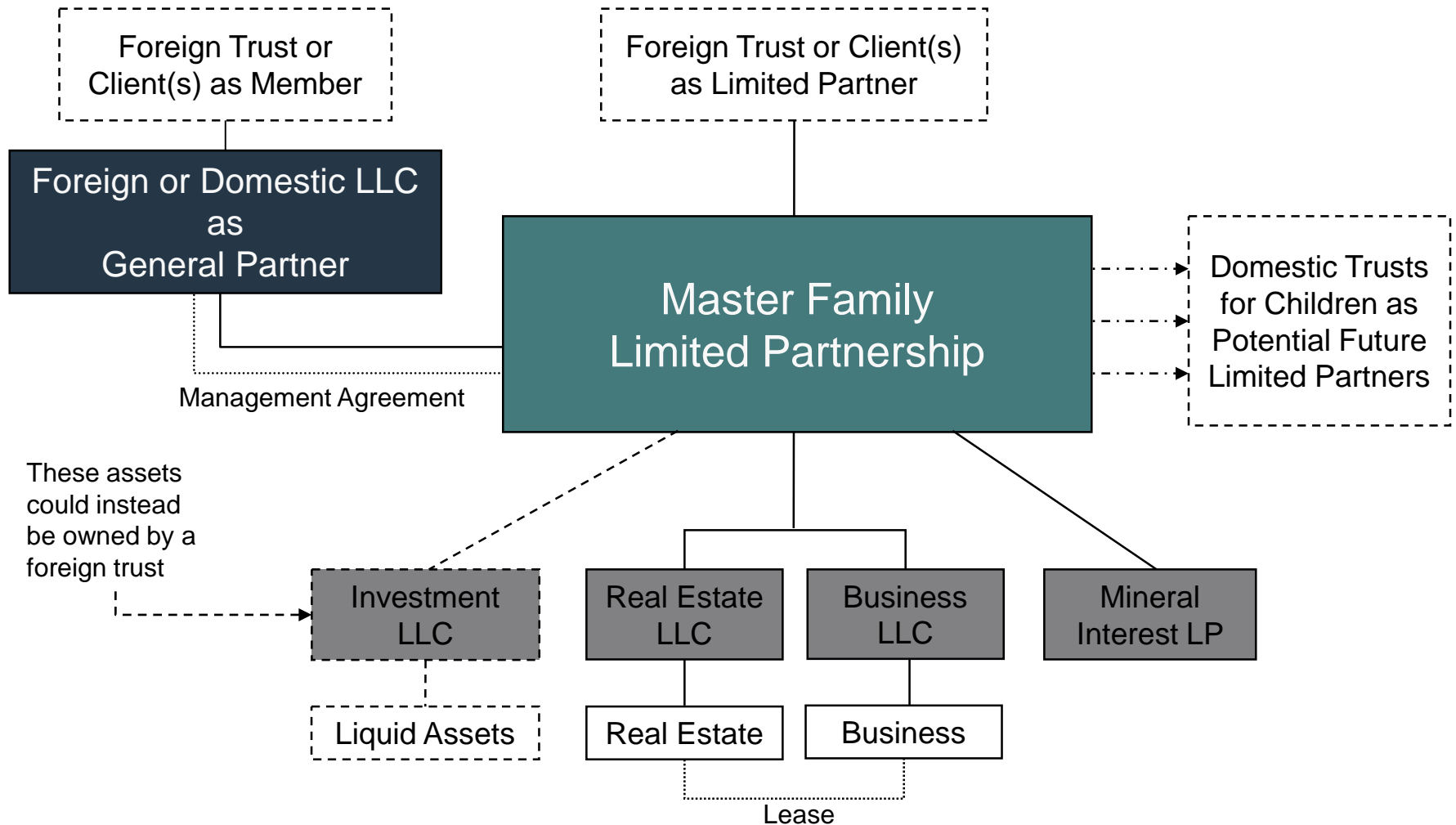
Foreclosure – Sources of State Laws

- Uniform Partnership Act (1997) § 504 states that a charging order constitutes a lien that can be foreclosed upon by order of the court
- Uniform Limited Partnership Act (1976) § 703 is silent as to foreclosure
- Uniform Limited Partnership Act (2001) § 703 states that a charging order constitutes a lien that can be foreclosed upon by order of the court
- Uniform Limited Liability Company Act (1996) § 504(b) states that a charging order constitutes a lien that can be foreclosed upon by order of the court
- Revised Uniform Limited Liability Company Act (2006) § 503(c) states that a court may order foreclosure upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time

Forced Dissolution

- Limited Liability Companies – depends on source of the state’s law: the 1996 or the 2006 Uniform LLC Act
 - 1996 Uniform LLC Act § 503 allows a transferee after foreclosure to petition the court for a dissolution of the company
 - 2006 Uniform LLC act does not contain this provision
 - Dissolution has also occurred in the bankruptcy context
- Partnerships & Limited Partnerships – no dissolution provision in any version the Uniform Acts

Master Family Limited Partnership Structure



What is an “Asset Protection” Trust?

- **Definition:**

- The settlor (the person who transferred assets to the trust) is a beneficiary of the trust; and
- The assets that the settlor transferred to the trust are protected from the claims of the settlor’s creditors

- Sometimes also referred to as a “self-settled spendthrift trust”

Protective Trusts: Foreign or Domestic

- **Domestic**

- Available in 15 states: Alaska (1997), Delaware (1997), Nevada (1999), Rhode Island (1999), Utah (2003), Missouri (2005), South Dakota (2005), Tennessee (2007), Wyoming (2007), New Hampshire (2008), Hawaii (2010), Virginia (2012), Ohio (2013), Mississippi (2014), West Virginia (2016)
- Also, to a lesser extent, Colorado (1994) and Oklahoma (2004)

- **Foreign**

- Available in many foreign countries

Texas Asset Protection Trusts?

- Section 112.035(g) of the Texas Trust Code (added in 2013) opens with:

For the purposes of this section, property contributed to the following trusts is not considered to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts may not be treated as a settlor: . . .

- 2013 amendments (generally) cause Texas trust law to follow identity of transferor under federal transfer tax laws

Permitted Self-Settled Spendthrift Trusts in Texas

- **Spousal Trust** – whether it qualifies for federal gift-tax marital deduction or not
 - Example: W transfers funds to *inter vivos* trust for H and makes proper QTIP election on Form 709; if W survives H, then assets are held in further trust for W
 - Example: W transfers \$5.45 million to discretionary trust for H and treats it as a taxable gift on Form 709; if W survives H, then assets are held in further trust for W
 - IRC Section 2037 (reversionary interest) issues
 - Perhaps better to give H or an independent trustee a power of appointment with W as permissible appointee, rather than W expressly retaining an interest

Permitted Self-Settled Spendthrift Trusts in Texas

- **“Reciprocal” Spousal Trusts**

- An irrevocable trust for a person, if the settlor was the person’s spouse, “regardless of whether or when the person was the settlor of an irrevocable trust for the benefit of that spouse”
- Example: H and W partition \$10.9 million of community property. H settles trust for W, and W settles trust for H with their shares of the partitioned property.
- Trust terms should vary sufficiently to avoid federal reciprocal trust doctrine
 - No state-law uncrossing of trusts for creditor purposes: provides estate-tax certainty for non-reciprocal trusts

Permitted Self-Settled Spendthrift Trusts in Texas

- **General Power of Appointment Trust**

- Statutory language somewhat ambiguous: “an irrevocable trust for the benefit of a person . . . to the extent that the property of the trust was subject to a general power of appointment in another person”
 - Does protection apply to a trust where the GPOA is still outstanding?
 - Begs the question whether GPOA may exist for only a moment in time (subject to transfer tax implications)

- **Example:** A creates an irrevocable trust for the benefit of A and A’s descendants and grants to C an *inter vivos* general power of appointment over the trust property, which lapses

Permitted Self-Settled Spendthrift Trusts in Texas

- **Trusts Established by Exercise of Power of Appointment (General or Limited)**
 - Example: *inter vivos* QTIP where donor-spouse does not retain interest following death of donee-spouse, but relies on donee-spouse's appointment back
 - Example: trust for settlor's spouse and descendants, where third party is granted limited power to appoint assets in further trust for a class that includes the settlor
- Power of appointment must be exercised, but need not be a general power

Vulnerabilities of Domestic Asset Protection Trusts

- Access to trust assets through U.S. court system
- U.S. Constitution

Offshore Protective Trusts Offer Additional Benefits

- Creditors cannot reach assets through U.S. court system
- U.S. judgments are not enforceable
- Cost of pursuing assets offshore is high; loser-pay systems
- Punitive damages and contingent fee contracts not allowed
- Secrecy and privacy laws prevalent and strictly enforced

When To Settle a Protective Trust

- **Before Insolvency**

- Cannot make a fraudulent transfer under state law or bankruptcy law; a 10-year claw-back period may apply in bankruptcy

- **Before a claim arises**

- The greater the distance in time between the transfer and a claim, the better

Asset Protection is a Spectrum

Less Asset
Protection

More Asset
Protection



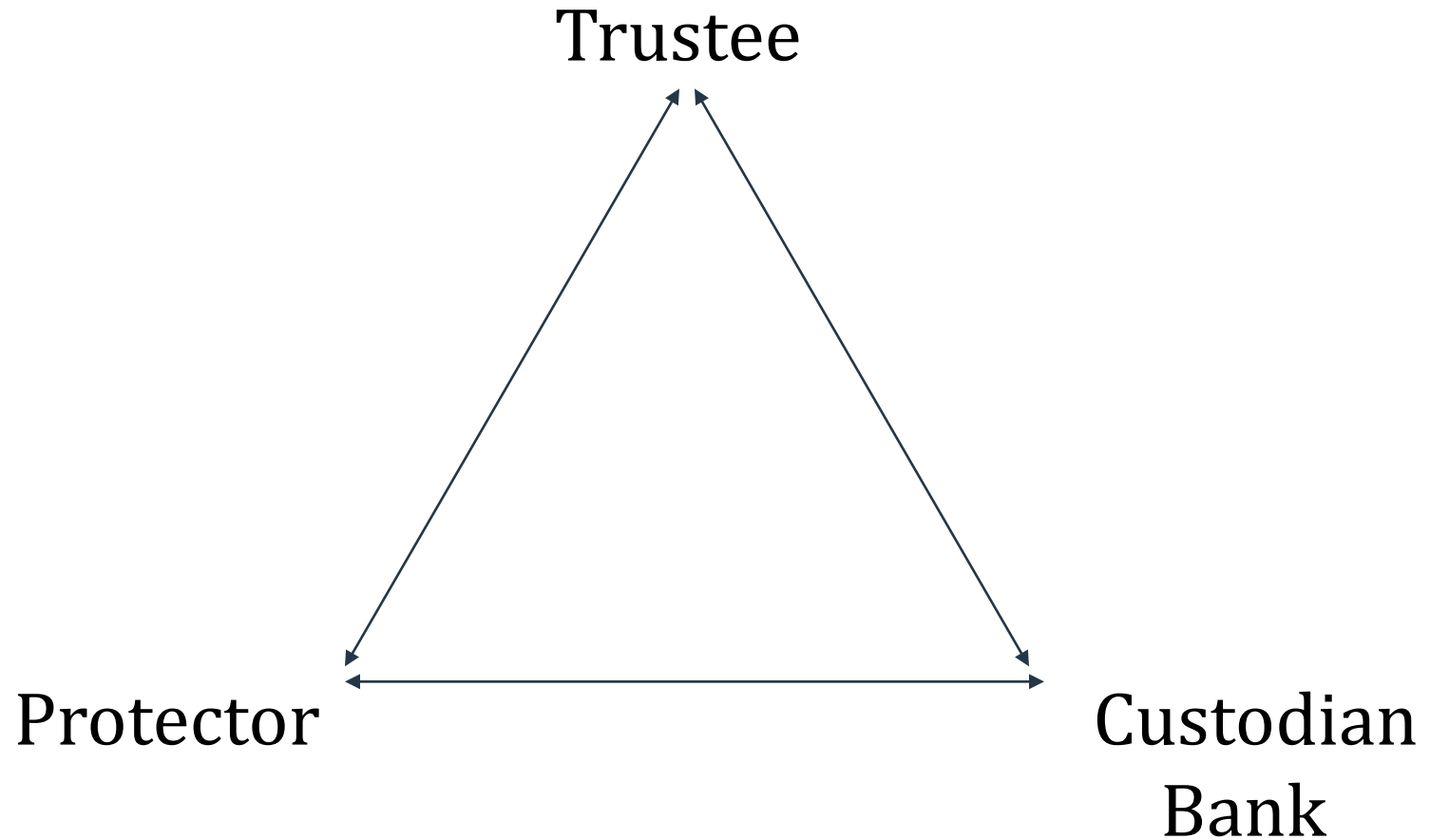
Greater Settlor control

Less Settlor control

More U.S. contacts

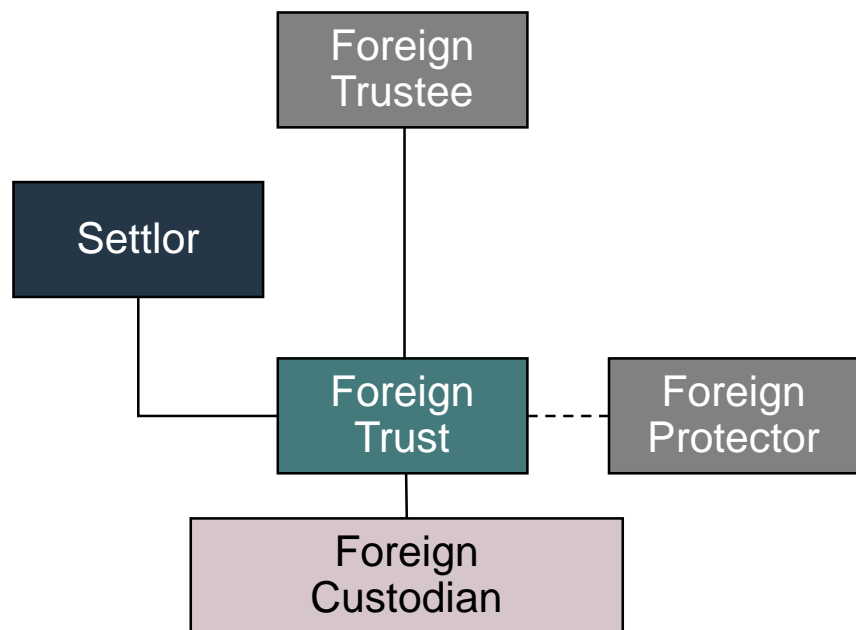
Few or no U.S. contacts

Check and Balance System



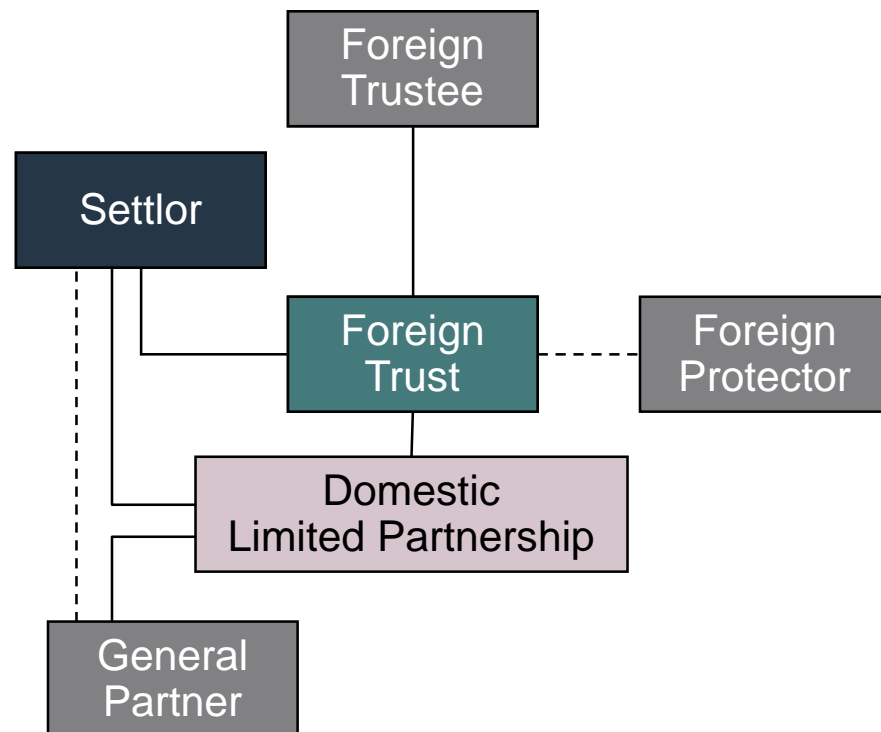
Two Fundamentally Different Offshore Strategies

EXPORT THE ASSETS



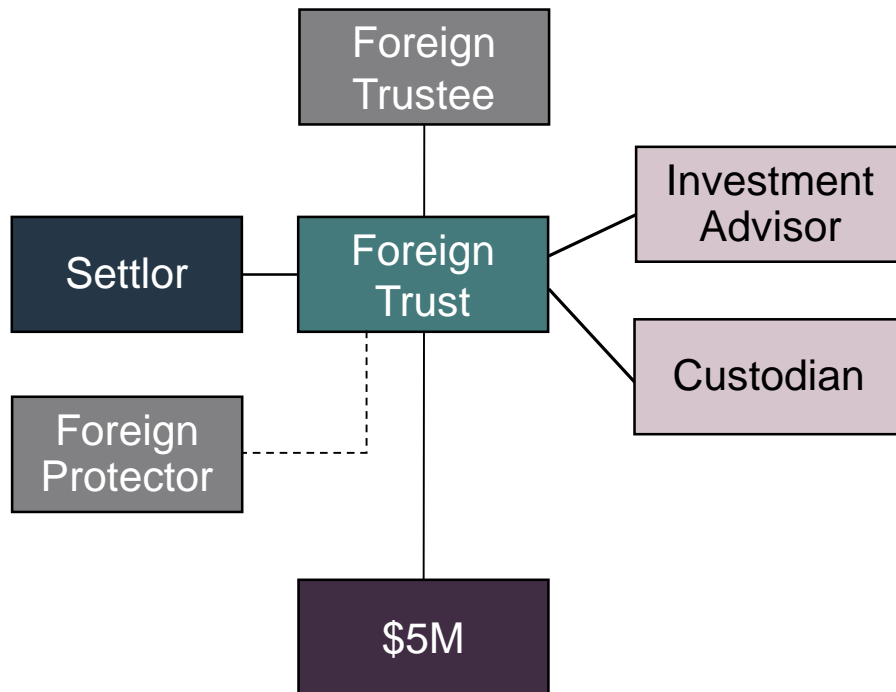
JURISDICTIONALLY SEVERED

IMPORT THE LAW



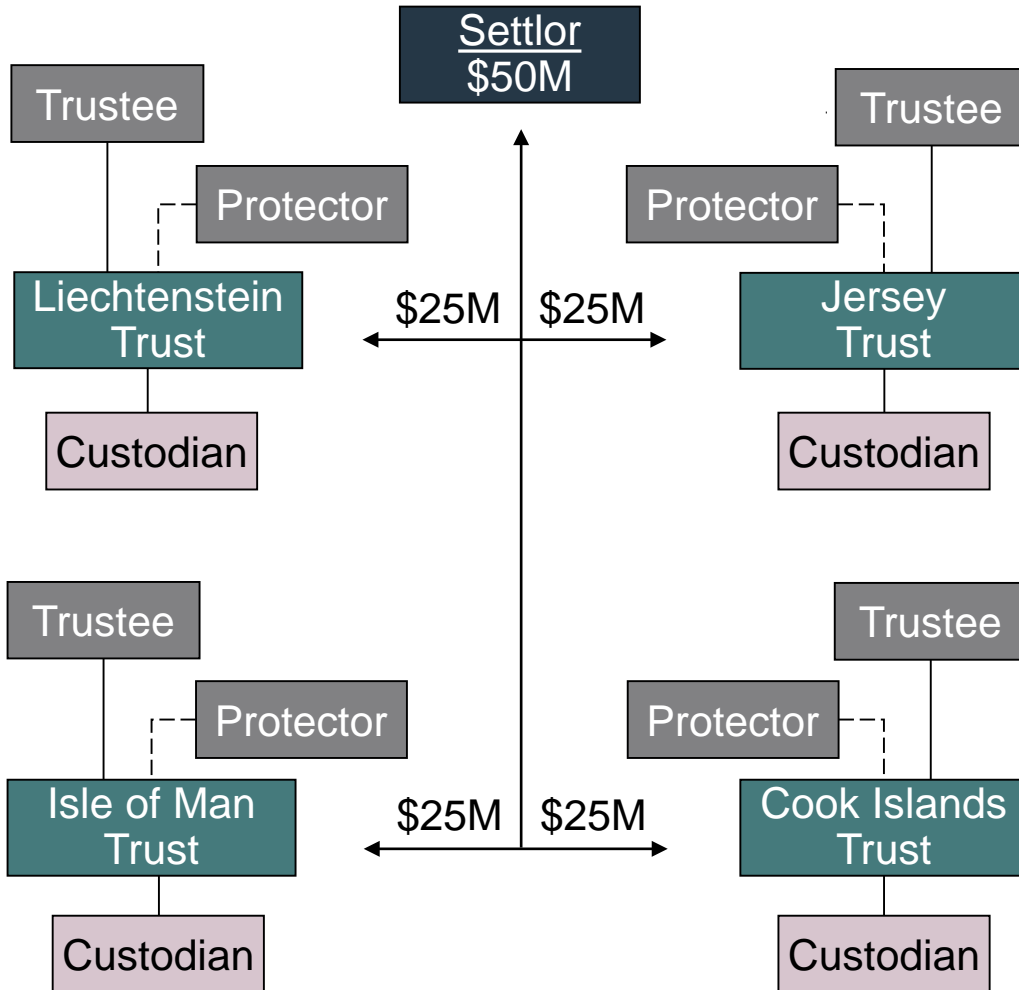
JURISDICTIONALLY CONNECTED

Nest Egg Trust



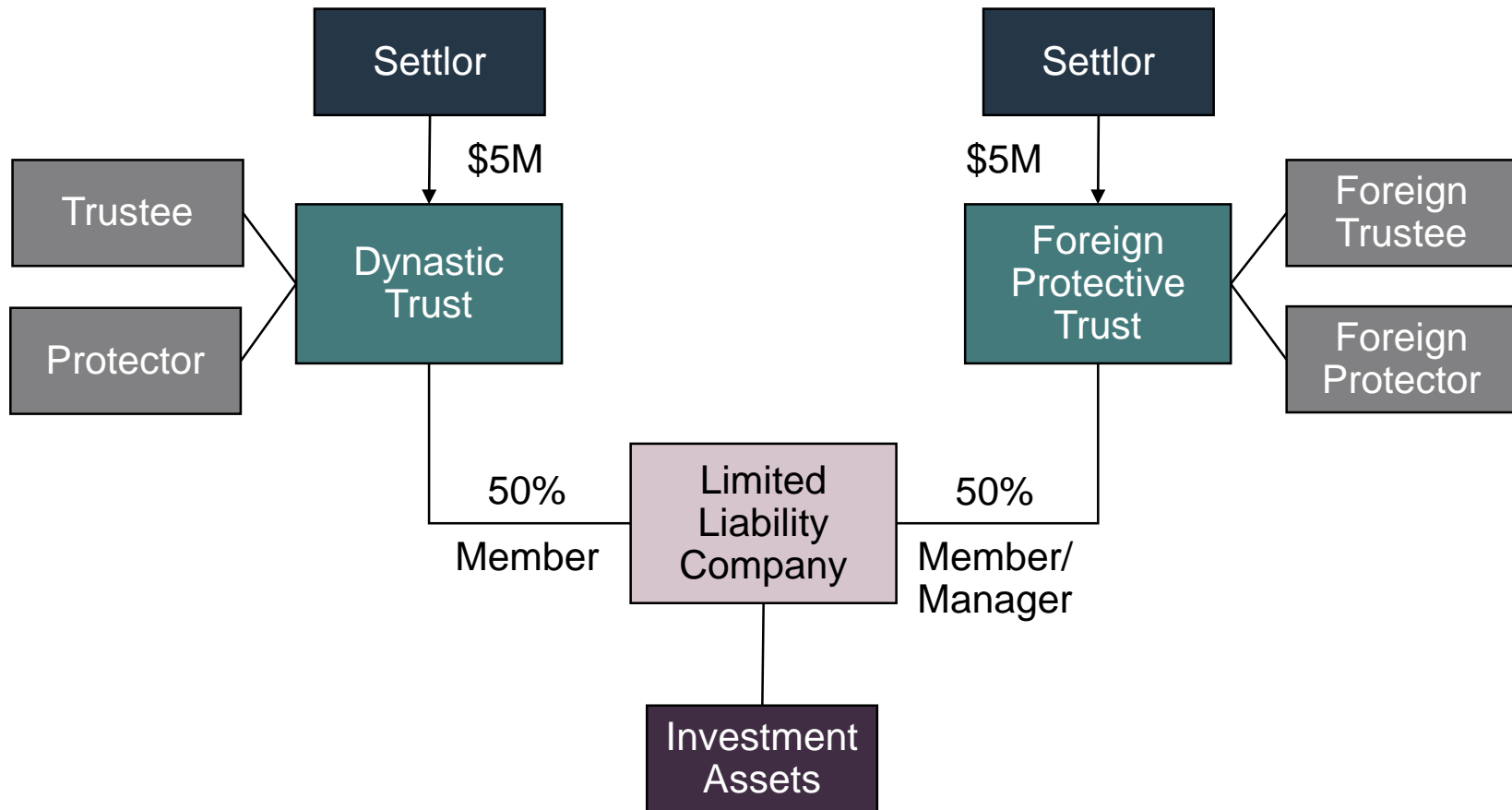
- Settlor has \$20M total assets
- Settlor has \$10M investment assets
- Settlor retains \$5M of investment assets personally and funds trust with \$5M
- Investment advice to Settlor and to Trustee may be provided by pre-selected investment advisor
- Contributions to trust are not subject to gift tax
- Settlor is subject to income tax on all earnings of the trust
- Trust assets are includible in settlor's estate for estate tax purposes

Multiple Trusts



- Settlor has \$250M total assets
- Settlor has \$150M investment assets
- Settlor retains \$50M of investment assets personally and funds four trusts with \$25M each

Combination of Trust Structures



Selection of Foreign Jurisdiction

- **“Traditional” Jurisdictions**
 - Jersey
 - Guernsey
 - Liechtenstein
 - Isle of Man
 - Bermuda

Selection of Foreign Jurisdiction (cont'd.)

- **Established “Asset Protection” Jurisdictions**
 - Cayman Islands
 - Bahamas
 - Gibraltar
 - Belize

Selection of Foreign Jurisdiction (cont'd.)

- **New “Asset Protection” Jurisdictions**

- Cook Islands
- Nevis
- Turks & Caicos
- Mauritius
- Niue
- St. Lucia

Liechtenstein

- Loser Pay (and deposit 10–15% of asserted damages with court before filing suit)
- No punitive damages
- No contingent fee contracts
- Must engage Liechtenstein counsel
- No enforcement of foreign judgments (except Swiss and Austrian judgments)
- Legal proceedings conducted in German
- No “specific” asset protection laws

Cook Islands

- Highly “specific” asset protection laws
- Fraudulent transfer
 - Burden on creditor to prove beyond a reasonable doubt that:
 - transferor specifically intended to defraud creditor-claimant; and
 - transferor rendered insolvent by transfer
- Statute of limitations
 - No transfer made more than two years before cause of action accrued is fraudulent
 - Creditor must sue within one year after transfer to Cook Islands trust

Costs of an Asset Protection Trust

- **Start-up**

- Legal fees
- Trustee fees
- Protector fees

- **Ongoing**

- Trustee fees
- Protector fees
- Legal fees
- Accounting fees
- Custodial fees
- Money management fees

Income Taxation

- Income Tax: taxed as grantor trust if settlor and at least one beneficiary are U.S. persons (IRC § 679)
 - All items of income, deduction, and credit flow through to Grantor

Capital Gain Taxation: Foreign Trusts and IRC § 684

- “Pure” Asset Protection Trust Can be Foreign
 - If foreign, no tax on transfer of appreciated assets because it’s a grantor trust; no tax on appreciated assets at grantor’s death because assets included in estate
- “Estate Planning” Asset Protection Trust Should Not be Foreign
 - If foreign, no tax on transfer of appreciated assets because it’s a grantor trust; but tax is imposed on appreciated assets at grantor’s death because not included in estate

Gift Taxation

- Gifts can either be complete (taxable gifts) or incomplete (no taxable gifts); incomplete gift requires retention by grantor of a certain amount of “dominion and control”
 - Traditionally, grantor’s retained beneficial interest plus retained testamentary limited power of appointment has been sufficient under the gift-tax regulations

Estate Taxation

- Structure a foreign trust to cause assets to be includible in the grantor's estate to avoid IRC § 684
- Domestic trust can be structured to avoid inclusion of assets in the grantor's estate

Primary Foreign Trust Filing Requirements

- **Form 3520:** Annual Return to Report Transactions with Foreign Trusts
- **Form 3520-A:** Annual Information Return of Foreign Trust with U.S. Owner
- **Form 1041:** U.S. Income Tax Return for Estates and Trusts (with Grantor Trust Information Letter attached)

Primary Foreign Trust Filing Requirements (cont'd.)

- **Form 709:** United States Gift (and Generation-Skipping Transfer) Tax Return
- **Form 8938:** Statement of Specified Foreign Financial Assets
- **FinCEN Form 114 (formerly TDF 90-22.1):** Report of Foreign Bank and Financial Accounts (“FBAR”)
- **Forms 8858, 8865, 5471 . . .**



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