

Don't Let the Tax Tail Wag the Dog: Client Concerns, Not the Estate Tax, Should Drive Estate Planning

Washington's negotiations about 2013 tax laws are getting lots of press. As estate planning professionals, we are often asked our opinions about what the 2013 estate tax laws might be and the resulting implications for our clients. But for the vast majority of Americans, what the estate and gift tax laws will be in 2013 is really irrelevant. Those who could make large gifts have probably done so in 2012, and the 2013 estate tax exemption is only relevant to those who have a 2013 death.

Yes, it is important for us to be aware of the state of the tax law. We can keep our ear to the ground for warnings of change emanating from Washington, but nobody has any kind of a handle on what the law will be in 5, 10, 15 or 20 years! What we all need to do is redirect our clients' inquiries to their real concerns: protecting their families and assets; preserving the family business; making sure their children are provided for, educated and motivated; seeing that their loved ones have enforceable rights where the law may not grant them; and making sure their plans do not self-destruct for lack of proper maintenance. These are the enduring issues that drive estate planning, regardless of what the estate tax law may be at any given time.

In this issue of *The Wealth Counselor*, we will take another look at one of those client concerns -- asset protection. With our increasingly litigious society, asset protection planning has become more important and is often a key motivator for clients who need other estate planning, too.

What is Asset Protection Planning?

Asset protection planning is not hiding or concealing assets. Rather, it is helping clients use existing laws appropriately to obtain the best possible level of protection for their assets against possible attack by creditors. The goal is to make planning decisions that are effective if and when needed because they have legitimate non-asset protection purposes and thus are defensible.

The best and most effective time to implement asset protection planning is before a claim arises, when the client is merely worried that someday there may be claims founded on possible events that have not yet happened. But even after a claim has been made, some opportunities (such as making a contribution to an ERISA qualified plan or doing a Roth conversion) may still be available to shield some assets.

Types of Client and Asset Risks

Almost every client would benefit from some asset protection planning, but like most things in life there is a cost to achieve the benefit. Asset protection planning is advanced planning and requires collaboration from a team of advisors, so sometimes the cost outweighs the benefit. Therefore it is important that each member of the advisory team be able to recognize the types of clients whose profile indicates they might be good prospects for asset protection planning. Here are a few of the main ones:

Professionals

The clients who are the best prospects for asset protection planning are those most likely to be sued. At the top of the list are physicians, surgeons, dentists and other health care professionals. Running a close second are lawyers, architects and accountants. A third category is clients involved with business enterprises that pertain to health care, such as skilled nursing facilities and assisted living facilities. Builders, developers and others in

construction are also at risk. Those who have already gone through a lawsuit will be keen to avoid the fear of loss associated with another one.

Planning Tip: *A professional is liable for the consequences of his or her own negligence and everyone makes mistakes. Therefore, a professional's liability protection should begin with adequate malpractice or errors and omissions insurance coverage.*

Partners

In a general partnership, each partner is liable for the negligent acts of every other partner and every employee. It is rare to encounter a general partnership of medical professionals, but much more common with lawyers and architects. Plus, partnerships can come into existence without any paperwork as a business is started and then the clean-up sometimes doesn't get done as the business grows.

Entrepreneurs and Executives

Attacks on entrepreneurs could come from business deals that have gone bad or tort claims. Management level personnel are exposed to claims for alleged improper employment practices, employment discrimination, or sexual harassment.

Landlords

Clients who own residential rental properties have often acquired them one-by-one over time. Frequently they are owned in the landlord's name. Every residential property exposes its owner to premises liability claims, such as for injuries from fires and slip-and-fall accidents. Legal structures can be set up that isolate a property from these risks associated with another property and separate the landlord from all the risks.

The Wealthy

The wealthy are exposed to more risk of lawsuits because they have the ability to pay and juries are often sympathetic to the plaintiff when the defendant is rich. Also, they often have staff, multiple properties and multiple vehicles and those impose claim risks, too.

Lifestyle-Based Candidates

Clients who have had more than one spouse are statistically at higher risk of divorce than those in first marriages. Many a business has collapsed as a result of an ex-spouse claiming an ownership interest in the business.

A client's child who engages in risky or antisocial behavior creates a risk of future unnecessary dissipation of a family's wealth; often leaving the child destitute with no one to turn to once the parents are gone.

Levels of Asset Protection

Every asset protection plan is a unique creation designed to meet the particular client's needs, risks and concerns. Typically, an asset protection plan employs a combination of strategies. Because asset protection planning is a process that frequently takes months to fully implement (and because wisdom dictates building the foundation before starting on the roof) in general asset protection planning should be implemented by levels, starting at the lowest. The lower rungs on the ladder don't get you very far off the ground, but they are dangerous to skip. Asset protection planning works the same way. A typical planning level strategy that would be presented to a highly compensated professional in a high risk profession would be:

Level 1: Exemptions

Level 2: Transmutation or Tenancy by the Entirety Agreements

Level 3: Professional Entity Formation (PA/PC/PLLC)
Level 4: FLP/FLLC to Own and Lease Practice Assets
Level 5: FLP/FLLC to Own Non-Practice Assets
Level 6: Domestic (U.S.-Based) Asset Protection Trusts
Level 7: Offshore Asset Protection Trusts

Below we discuss each of these seven levels.

Planning Tip: *The plan presented should include levels above those that the client will probably choose. This gives the client appropriate control and decision making responsibility and also avoids the risk of the client legitimately complaining that particular strategies were not offered.*

Level 1: Exemptions

Some assets are automatically protected by state or federal exemptions. State exemptions can include personal property, life insurance, annuities, IRAs, homestead, and property held in tenancy by the entirety. Each state protects its citizens' assets differently and the amounts of the exemptions will also vary greatly from state to state. For example, some states have an unlimited homestead exemption (Virginia does not); many states protect all IRAs (Virginia protects IRAs up to \$1,000,000); and many non-community property states, such as Virginia, recognize tenancy by the entirety, which is sometimes a great way to shelter the interests of both the spouse who is at risk and the spouse who is not.

Federal exemptions include ERISA which covers 401(k) and 403(b) plan accounts, pensions, and profit-sharing plans. Creating and funding qualified retirement plans for clients can provide excellent shelters against creditors' claims. Typically these plans must also include one or more non-owner employee participants in order to be covered by ERISA. Skillful pension actuaries can be very helpful with this.

While the federal Pension Protection Act protects up to \$1 million in IRAs and Roth IRAs for bankruptcy purposes, the level of non-bankruptcy protection afforded by the states to their citizens' IRAs varies widely.

For a client who lives in a state with weak IRA protection, it might be best to move unprotected IRA assets into an ERISA qualified retirement plan which is unreachable by third-party creditors during the pay-in period (some portion of required minimum distributions may be reachable by creditors). For the client who lives in a state with strong IRA protection, like Virginia, or who has not used all of the IRA protection available in their state, converting a traditional or roll-over IRA into a Roth IRA and paying the taxes with non-IRA funds can be an excellent asset protection strategy that is easily and quickly implemented.

Planning Tip: *With today's low interest rates, defined benefit plans are becoming popular again. Instead of the required annual fixed contributions of the past, the IRS now allows almost as much flexibility with defined benefit plan contributions as it does with profit-sharing plans. Contributions can also be increased dramatically to allow for the use of life insurance within the plan. Life insurance can be an especially valuable asset because death benefits are not subject to income or capital gain tax, and if the policy ownership and control is done right, the death benefit is not part of the insured's taxable estate.*

Planning Tip: *Sometimes it is possible to convert non-exempt assets into exempt assets. For example, cash (a non-exempt asset) can be used to pay down a homestead mortgage and increase exempt home equity. This is a strategy for clients who live in states with a*

large or unlimited homestead exemption.

Planning Tip: *Because home mortgages and home equity lines of credit are currently hard to get, a qualified personal residence trust (QPRT), established as an ongoing trust to benefit younger family members, can also be used. However, because it is a self-settled irrevocable trust, some states have limitations that can reduce a QPRT's effectiveness for asset protection. Also, putting an unprotected home asset into a QPRT when there is a known or anticipated claim could be held to be a fraudulent transfer.*

Planning Tip: *The exemption level asset protection strategies may even be available to the client who has already been sued.*

Level 2: Transmutation or Tenancy by the Entirety Agreements

There are asset protection strategies for married clients that depend on how title is held to an asset. In Virginia of the states, the available technique is converting jointly held property to tenancy by the entirety property. In the nine community property states, the technique of choice is the agreement to transmute community property into separate property. Both techniques have legal consequences beyond asset protection that must be explained to, understood and accepted by the client.

Converting jointly held property into tenancy by the entirety can make it inaccessible to an at-risk spouse's creditors while the other spouse is living. [Further, Virginia law allows tenants by the entirety property to be conveyed to a revocable living trust without losing the creditor protection.] Transmutation agreements allow clients to convert community property assets into the separate property of the spouse not at risk. Make sure the client is aware that property once transmuted stays separate property unless and until another transmutation agreement converts it back to community property. Separate counsel for each spouse may be needed to make a transmutation agreement binding. Plus, there may be enhanced risk of loss of property in case of a divorce.

Level 3: Professional Entity Formation (PA/PC/PLLC)

General partnerships and sole proprietorships under which a professional is conducting business should be restructured as a professional association or corporation (which depends on state law) or a professional limited liability company. By so doing, each professional will become protected from personal liability for the errors of other professionals and employees. Putting that protection in place is a good second step beyond having adequate malpractice insurance.

State laws will vary on this, but fortunately Virginia law recognizes PLLCs. If available, a PLLC is usually more desirable because of the charging order limitations that prevent a professional's creditor from seizing any assets from the entity, limiting the creditor to only receiving distributions that would have been made to the affected debtor-member. In addition, the creditor may have to pay tax on any income that is distributed under a charging order. This is often enough to discourage a creditor from pursuing a claim or to make settlement on a favorable basis possible. Establishing the entity under the laws of a state that has the charging order as the sole creditor remedy, when that is possible, should also be considered.

Level 4: LP/LLC to Own and Lease Practice Assets

An LP or LLC can be created to own the specialized or valuable equipment and/or real estate that is used in the professional practice. "Lease back" agreements can then be created between the professional practice and the property owning LLCs. This strategy allows the professional to isolate valuable real estate and equipment from malpractice exposure. In

some cases, a factoring arrangement can put the value of the practice's accounts receivable in the LP or LLC and thus beyond the reach of a malpractice creditor.

Planning Tip: *Creating an LP or LLC to own practice assets also allows for good estate planning by providing the opportunity for gifting or sale of LLC/LP interests to irrevocable trusts established for the benefit of children or other family members.*

Level 5: FLP/FLLC to Own Non-Practice Assets

Consider the formation of a family limited partnership or family LLC in a favorable jurisdiction that has the charging order as the sole remedy to own non-practice assets. This entity would hold personal use real estate, investment accounts, cash or bank accounts, and investment real estate. Having a multi-member LLC increases the charging order protection because a bankruptcy judge cannot collapse a multi-member LLC that was formed in a favorable jurisdiction.

Level 6: Domestic (U.S.-Based) Asset Protection Trusts

Historically, creditors were able to reach assets that their debtor had placed into an irrevocable trust for the debtor's benefit. Such trusts are called "self-settled." Starting with Alaska in 1987, several states, including Virginia in 2012, have adopted laws that allow the assets of certain self-settled trusts to be protected from the grantor/beneficiary's creditors. These trusts are called asset protection trusts. Because they are formed under a state's jurisdiction as opposed to the jurisdiction of another country (see Level 7, below) this kind of trust is commonly referred to as a Domestic Asset Protection Trust (DAPT).

The time between creating the DAPT or placing an asset in the DAPT and the DAPT affording protection to that or all DAPT assets varies from state to state, with the shortest time being two years. In like manner, the states have different lists of creditor or claim classes to which the DAPT's asset protection does not apply.

In Level 6 planning, the client establishes a DAPT in the selected jurisdiction and funds it with non-practice, non-leasing LLC assets.

Each DAPT state has its own rules that will need to be satisfied for a DAPT established under its laws to be effective. For example, the state's DAPT law may require that a trustee have an office in that state or that some of the trust assets be held there. Associating local counsel in the chosen DAPT jurisdiction may be appropriate.

Planning Tip: *Because clients today are often living into their 90s, it is wise to build flexibility into a DAPT or other irrevocable trust to accommodate changes in a client's needs and family over several decades. To do this, the trust can be made changeable by an independent third party of the client's choosing. This role is commonly referred to as the "Trust Protector."*

Planning Tip: *A trust can be designed so that transfers to it are, for gift and estate tax purposes, completed or incomplete gifts. Incomplete gifts are included in the grantor's estate for estate tax purposes and get a basis adjustment at death. The opposite is true for completed gifts that are not brought back into the grantor's estate under what are called the "string" sections of the Internal Revenue Code (26 USC §§ 2035-38 and 2042). Be sure to determine what is best in each case.*

Level 7: Offshore Asset Protection Trusts

The highest (and most expensive to establish and maintain) level of asset protection planning is founded on one or more asset protection trusts established under the laws of a

foreign jurisdiction. (The Cook Islands, the Bahamas, Bermuda and the Channel Islands are all popular choices.) With an offshore trust, the assets are in the hands of a local trustee and are outside the reach of any U.S. court. However, there may be tax issues. Also, if the court orders the assets repatriated and they can't be, the client could be cited for contempt and even jailed.

Planning Tip: *An offshore asset protection trust should not hold assets in the United States over which a U.S. court could exert jurisdiction.*

Implementing the Asset Protection Plan

The advisors independently and collectively will make a list of the client's assets and determine what needs to be done with each one to implement the levels of planning selected by the client. It can easily take six months to a year to design, implement and fully fund a comprehensive asset protection plan, and it's usually done in steps and pieces. During the process, it's very important to keep the client informed and keep everyone on a timeline.

Protecting the Advisor Team

Asset protection planning can pose a risk to the advisor team members' assets. Those risks need to be avoided. One risk is the client who, when his or her assets are under attack, will forget that no advisor guaranteed the plan's success. The other risk is that the client's creditors, who just want money and don't care who pays, may try to bring the asset protection planning team members into the fray under "fraudulent transfer" allegations.

Tempering Expectations and Documenting the Agreement

To deal with the first risk, it is important to set some reasonable expectations for the client and for the client to be educated about what asset protection is, how the laws work, and what the client can reasonably expect to achieve. For example:

- * Most people would like to have a high degree of certainty of the outcome. The advisors have to temper that expectation by explaining how the law works and that there may be circumstances that nobody can effectively control. Asset protection is time consuming, but worthwhile. The end result should be considerably better than if the client had done no planning at all.
- * Many clients want to maintain control rather than shift assets to some unknown third party in a foreign land. The preferred approach is to maintain control or at least oversight over the assets.
- * An effective plan will discourage lawsuits from the outset. We cannot make our client's assets appear not to exist, but we can create a structure that will make it less attractive for a potential plaintiff to go after our client than to go after someone who has done no planning. And we can enhance our client's ability to negotiate a favorable settlement if liability is established.

We very highly recommend that a detailed written asset protection engagement agreement be signed in all cases. The agreement should spell out the plan goals, limitations and potential risks and negate the idea of there being any guarantee of success.

Avoiding Fraudulent Transfer Exposure

The natural tendency of the debtor is to hide assets to frustrate the creditor who would seize them. To deal with that problem, there are "fraudulent transfer" laws. Each state has one and there is one in the Bankruptcy Code. In general they allow a creditor to unwind certain transactions in which the debtor has transferred assets to another for anything short of full and fair consideration with the intent of hindering or defrauding creditors. These laws also impose personal liability on anyone who aids or abets the debtor in these activities.

Therefore, the advisor team members all want to make sure that they have a good defense to any frustrated creditor's claim that they took any action that was reasonably calculated to aid their client in implementing a fraudulent transfer.

The key to the advisor team members avoiding exposure to a claim of abetting fraudulent transfer is to make sure to gather financial and objective information and to build a relationship with the client before designing or implementing the asset protection planning. Once the facts are known, no matter how bad they are, some level of asset protection planning can probably be done. Without knowledge of the facts, the asset protection plan designed by the advisors is likely to fail.

Planning Tip: *Because the natural tendency of many is to procrastinate, often the client who seeks asset protection planning already has a claim pending or impending against them.*

Planning Tip: *Because asset protection planning is most attractive to those who have a higher than average risk of being sued, it is critically important to determine early in the planning process how much information the client is willing to share and should share with various members of the advisor team. For example, it may be vital to preserve attorney/client privilege about some things and therefore not share specific risk information with non-attorney advisors who could be subpoenaed. Short of being sued, there is not much worse for an advisor than to be called to testify against a client!*

Planning Tip: *Clients may misrepresent their legal difficulties, and none of us wants to subsidize a plaintiff's claim through the use of our own malpractice insurance because of not asking the right questions or doing a thorough discovery. An excellent practice is to have in your file a solvency certificate from your client in which the client represents to you in writing that their net worth is a positive number and that the planning they are going to do will not render them insolvent. In some instances it is useful to obtain permission from the client in order to do due diligence and independently investigate to make sure you know the information provided is accurate.*

Conclusion

Asset protection planning is just one client concern that can be the impetus that gets the client to do estate planning. While it is highly important that the advisor team members know and understand the current estate tax laws, nobody knows what those laws will be in the future when the client's planning "matures." Other than in very rare cases, the current tax laws themselves are irrelevant to, and are rarely the motivating factor for, our clients' planning. What our clients want and need is predictability coupled with flexibility. Members of the advisory team who are aware of the enduring concerns clients have will find many opportunities to work together for the benefit of the team members and their clients.

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