September – October 2007

Asset Protection Planning to Keep Creditors and Predators at Bay

*By Robert S. Keebler**

In the past 36 months, more and more clients seem to be asking about asset protection planning. Although we can speculate about the genesis of these questions, it is likely that as clients pay less and less attention to the estate tax, clients and lawyers alike are addressing the brutal reality of "creditors and predators" and how to protect themselves, their children and their grandchildren.

For most families, the best asset protection begins with insurance and a substantial umbrella policy. Additionally, the utilization of well-drafted trusts for lifetime gifts and transfers upon death provide significant asset protection. The concept of a "spendthrift" trust is simple and discussed below.

Beyond the use of insurance and spendthrift trusts, bankruptcy and asset protection attorneys often rely upon Employee Retirement Income Security Act of 1974 ("ERISA")[1] plans, exemptions for IRAs, foreign asset protection trusts, family limited partnerships, domestic asset protection trusts, Code Sec. 529 plans, annuities and of course the Homestead exemption for asset protection.

Sometimes, however, asset protection must focus on compartmentalizing risk by using LLCs, S corporations, C corporations and limited partnerships with a corporate partner. For example, for a client with 100 apartment buildings, it would be wise to hold these buildings in a series of LLCs. That way, if a judgment occurs, the damage will be limited to the LLC that owns the particular building where the injury or other tort liability arose.

No matter the asset protection vehicles chosen by the client, it should be stressed that time is of the essence when dealing with asset protection planning. Due to the fraudulent transfer laws, planning which occurs too late (*i.e.*, too close in time to the happening of a potentially negative event) can be considered fraudulent and disregarded for asset protection purposes. Therefore, clients will best protect themselves and their assets by planning early and planning often!

The following summary will provide an overview of each of the above mentioned asset protection vehicles. Furthermore, planning strategies will also be presented to help facilitate understanding and enable to reader to best assist their clients.

Adequate Insurance Coverage– The Primary Defense

As adequate insurance coverage is generally a family's first and principal defense against liability claims and judgments, it is logical that an effective asset protection plan generally begins with having the proper insurance coverage in place. Normally, this means having an umbrella policy to supplement the family's business, professional liability, homeowner's and automobile insurance policies.

For a relatively nominal cost, umbrella policies typically offer from $1 million to $50 million in additional coverage. Although not effective as an asset protection tool against all types of liabilities and losses, when used in concert with other asset protection measures, umbrella insurance policies are generally an extremely successful and cost effective measure. Especially considering the immense financial expense and exposure an underinsured individual and their family may be faced with.

Utilizing Trusts for Asset Protection Purposes

Trusts have a long history as asset protection instruments and vehicles through which to insulate assets

Robert S. Keebler, CPA, M.S.T., is a Partner with Virchow, Krause & Company, LLP, in Green Bay, Wisconsin.

©2007 R.S. Keebler

and garner protection from creditor's claims. Today, the utilization of trusts as asset protection tools has expanded and increased. In addition to the popular spendthrift trusts, individuals can now consider implementing foreign asset protection trusts and possibly even domestic asset protection trusts. However, the effectiveness of some of these newer trusts is not certain and the protection offered by may come at a price.

Spendthrift and Self-Settled Trusts

A spendthrift trust is one of the most effective and most commonly utilized asset protection vehicles. It is similar to a traditional trust except for the addition of a restraint on alienation or spendthrift clause. This clause gives the trust its asset protection features basically by providing that the undistributed principal and income of the trust shall not be subject to the claims of any of the beneficiary's creditors. These trusts are generally effective and upheld under state and federal laws if designed to protect the interests of the beneficiaries.

In comparison, spendthrift trusts designed to protect the interests of the settlor are termed "self-settled trusts." In these trusts, due to the fact that the settlor is one of the beneficiaries of the trust, they may be ineffective at providing asset protection for the settlor's assets. Accordingly, spendthrift trusts, which are ideal for making lifetime gifts and transfers upon death, should generally be established only to protect the interests of a beneficiary such as a spouse, child or grandchild and not those of the settlor.

Domestic Asset Protection Trusts

Although a self-settled trust may be a legitimate trust, unless it is established as a domestic asset protection trust in one of the few jurisdictions which have enacted domestic asset protection statutes, the trust will generally be ineffective for asset protection purposes.[2] Domestic asset protection trusts are basically self-settled trusts enacted in domestic jurisdictions which have enacted the requisite legislation. Furthermore, due to the fact that domestic asset protection trusts are relatively new, there has been no litigation either upholding or defeating their validity or effectiveness. Therefore, it is generally believed that these types of trusts will currently be most effective for individuals residing in jurisdictions which have enacted domestic asset protection legislation. Furthermore, it may be wise to pursue the counsel of an asset protection attorney prior to considering or enacting one of these new trusts.

Going Offshore: Foreign Asset Protection Trusts

Although domestic asset protection trusts are relatively new, the idea of going offshore and placing assets in foreign asset protection trusts is a commonly utilized, sophisticated asset protection strategy. Foreign asset protection trusts generally provide strong asset protection due to their establishment under the laws and jurisdictions of foreign countries which have more favorable asset protection and privacy measures, and which typically do not enforce U.S. judgments. Thus, even if a creditor is successful in attaining a judgment against a debtor, the creditor will probably have a difficult time, and suffer financial detriment, enforcing the judgment against a debtor's assets that are housed in a foreign asset protection trust. However, these trusts are not without their risks and uncertainties. The very features that make offshore trusts successful asset protection vehicles also make them risky.

In order to mitigate these risks, it may be beneficial to maintain more control over the trust assets placed in a foreign asset protection trust. To accomplish this goal, family limited partnerships (FLPs) or limited liability companies (LLCs) may be used in tandem with foreign asset protection trusts. In order for the settlor to retain control over the transferred assets while relinquishing ownership of the assets, generally the settlor either owns a minimal general partnership interest in the FLP, with the trust owning the limited partnership interests; or the settlor is named as the manager of the LLC with the trust owning the LLC interests. While the utilization of FLPs and LLC in tandem with offshore trusts is a complex asset protection strategy, it can also produce beneficial results.

However, as with domestic asset protection trusts, offshore trusts are best utilized after thorough counsel with an asset protection attorney, and only after the individual fully understands the possible risks as well as the benefits associated with this asset protection strategy

Federal Laws Providing Asset Protection for Assets in Qualified Plans and IRAs

The Employee Retirement Income Security Act of 1974 (ERISA)[3] and the Bankruptcy Abuse Prevention and Con-

CCH a Wolters Kluwer business

sumer Protection Act of 2005 ("the Bankruptcy Act")[4] are the two main bodies of federal law that provide asset protection for qualified plan and IRA assets.

ERISA, which applies to assets within covered employer retirement plans, is the primary federal law under which qualified plan assets receive asset protection. Although not all encompassing, for covered assets, the protection provided by ERISA is virtually impenetrable and takes the favorable form of an exclusion from the federal bankruptcy estate. In order to receive protection under ERISA, the retirement plan must be a covered plan and fall under the scope of ERISA regulation. The covered employee retirement plans which are regulated by ERISA, and are consequently afforded ERISA protection, include 401(k) and 403(b) plans, defined benefit plans, money-purchase plans and profit-sharing plans. Retirement plans such as Traditional IRAs, Roth IRAs, SEP and SIMPLE IRAs, and single participant (*i.e.*, husband and/or wife) retirement plans for self employed business owners, which are not covered by ERISA, are not afforded protection under ERISA. Additionally, ERISA protection is generally applicable independent of whether the debtor has filed for bankruptcy.

The second body of federal law affording asset protection to retirement plan assets is the recently enacted Bankruptcy Act. Simplifying and expanding the asset protection available for both ERISA and non-ERISA retirement plan assets[5] of debtors in bankruptcy, the Bankruptcy Act provides asset protection in the form of an exemption form the bankruptcy estate. Most significantly, the Bankruptcy Act codified the previously uncertain federal asset protection afforded Traditional and Roth IRA assets.

Under the Bankruptcy Act, creditor protection is now extended to all IRA accounts irregardless of state law. Presently, the Bankruptcy Act provides an unlimited exemption from the bankruptcy estate for all rollover IRAs and SEP and SIMPLE IRAs. Additionally, contributory IRAs (*i.e.*, Traditional IRA or Roth IRA) are afforded protection in the form of a $1 million exemption, which may be increased if the interests of justice require.

Planning Point

Due to the $1 million limitation placed on contributory IRA protection, it is always desirable to keep contributory IRAs and rollover IRAs separate. When rolling qualified plan accounts over into an IRA, the assets should be rolled into a new IRA set up to receive the rolled over funds. Furthermore, to ensure the unlimited exemption, care must be taken to keep the rollover IRA separate and not make any IRA contributions to or otherwise commingle contributory asset with the rollover IRA.

Planning Point for Qualified Plan Rollovers

When deciding whether to roll retirement plan funds from an ERISA plan into an IRA, it is generally advisable to seek the counsel of an asset protection or bankruptcy attorney prior to executing the rollover. This is because the decision does not hinge merely on income tax or financial planning considerations, but on legal implications involving the protection afforded the transferred assets.

In general, protection afforded assets in ERISA plans remains stronger than the protection afforded rolled over IRA assets. While ERISA plan assets receive an exemption in bankruptcy and are generally protected in nonbankruptcy situations, non-ERISA plan assets, although provided exemption protection under the Bankruptcy Act, must rely on the uncertainty of IRA protection under state asset protection laws in non-bankruptcy situations

Form of Organization and Asset Protection

An entity's form of organization generally will have a considerable impact on the personal asset protection risks faced by each of the partners/members of the organization. Generally speaking, the corporate form of organization will provide the most asset protection for the owner's personal assets because one of the characteristics of the corporate form of organization is limited liability. Additionally, the limited liability company (LLC) or limited liability partnership (LLP) form of organization will also provide substantial personal asset protection for a partner's personal assets. This occurs because the partners of LLCs or LLPs are generally not held liable for the professional malpractice or tortuous conduct of the firm or the other partners and employees of the firm.

On the other hand, the general partnership form of organization will generally provide the least asset protection for general partners because they will have unlimited personal liability for the professional malpractice or tortuous conduct committed by the firm and other partners and employees of the firm. Therefore, when approaching the entity formation question from an asset protection standpoint, incorporation,

CCH® a Wolters Kluwer business

LLCs or LLPs are generally a more favorable form of organization. General partnerships are typically not an ideal choice of organizational form and may result in substantial risk and asset protection issues.

Compartmentalizing Risk Through Multiple Entities

Organizational structure can serve as a means to limit liability and afford asset protection. When risk and problems are "compartmentalized" into different businesses or business units, a creditor's claim, although problematic for one business unit, will not destroy the entire entity. This type of asset protection is best illustrated through the example of a large corporation which in structured to have a parent holding company with a number of corporate or LLC subsidiaries. A problem which arises in any one of the subsidiaries would be isolated to that particular subsidiary, and would not destroy the entire company. Thus, the risk is "compartmentalized" and asset protection is achieved.

CCH® a Wolters Kluwer business

Code Sec. 529 Plans and Asset Protection

Assets in a Code Sec. 529 plan ("529 plan") may be afforded some asset protection. A 529 plan is a tax-exempt investment vehicle established and/or maintained by a state or eligible educational institution which allows an individual to contribute funds towards the future higher educational expenses of another individual. Due to the fact that only about 25 percent of states have passed asset protection legislation for 529 plan assets, the assets in 529 plans are potentially accessible by the creditors of the account owner, but generally not the creditors of the beneficiary. Thus, taking into consideration asset protection issues for these types of plans, careful consideration should be given to the decision as to who the plan account owner should be.

Time is of the Essence When Implementing an Asset Protection Plan

One of the key planning points when implementing an asset protection plan is to plan early and plan often. Because of the fraudulent transfer laws, which state that transfers occurring close in time to the happening of a potentially negative event such as a lawsuit can be deemed fraudulent by the court and rejected, it is paramount that an asset protection plan is established and in place before problems arise. Furthermore, due to changing laws and the evolving nature of portfolios, it is also important to consistently reevaluate asset protection measures to ensure their accuracy and sufficiency.

Conclusion

In light of today's increasingly litigious society, asset protection planning has recently come to the forefront as an important issue. While families and individuals can choose from an array of strategies ranging from sophisticated to the more fundamental, individuals should seek the counsel of an asset protection attorney to tailor their asset protection plan to their unique situation. Furthermore, even for families who employ only more fundamental measures such as insurance and spendthrift trusts, the asset protection plan must be established early and reviewed often. As time is of the essence in asset protection planning, this is truly one area where failing to effectively plan may result in dire consequences.

Endnotes

[*] Some of the materials in this article were derived in part from Robert S. Keebler, *New Protection for IRAs in Bankruptcy*, Taxes, June 2005, at 5.

[1] Employee Retirement Income Security Act of 1974 (P.L. 93-406).

[2] Alaska, Nevada, Delaware, South Dakota, Missouri, Utah, Tennessee, Wyoming, Oklahoma and Rhode Island have enacted statutes enabling self-settled spendthrift trusts.

[3] Act Sec. 4 of P.L. 93-406.

[4] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8).

[5] Under Section 224 of the Bankruptcy Act, protection is now provided for retirement assets to the extent that those funds are in a fund or account that is exempt from taxation under Code Sec. 401, 403, 408, 408A, 414, 457 or 501(a).

This article is reprinted with the publisher's permission from the Journal of Retirement Planning, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the Journal of Retirement Planning or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH.