Common Sense Thoughts On Asset Protection Planning

Robert E. Ward

Asset protection planning should be done early, carefully, and with a large element of common sense. The simplest asset protection alternatives should be used to the extent they prove sufficient to accomplish the client's goals.

There are two underlying issues that pervade all asset protection planning. These issues must be recognized and considered regardless of the particular asset protection technique used. These issues suggest the arguments most commonly advanced by creditors in response to asset protection planning:

1. No transfer of assets has been made.
2. The transfer, if made, was a fraudulent conveyance.

Failure to adequately address either of these issues and arguments will likely cause an asset protection technique to be unsuccessful. To implement any of the asset protection techniques, currently owned assets must be transferred. If that transfer can be characterized as a fraudulent conveyance, the transfer can be reversed, thus allowing creditors to reach the assets.

An attack consistently mounted by creditors when confronted with asset protection planning is that, in fact, no transfer has ever occurred. Essentially, this argument is one of substance over form. Although legal title or beneficial interest in an asset may have changed from the transferor to a third party, in reality, the transferor still controls the transferred assets. The nominal owner is acting solely as the agent of the transferor. Creditors are aided with this argument by the fact that most asset protection techniques involve retention of some degree of control. There is no "bright line" to distinguish how much control is too much. The facts and circumstances of the ongoing relationship the transferor has with the transferred assets must be examined. In planning to implement any asset protection technique, the transferor should retain no more control than is absolutely necessary. The transaction should be designed to buttress the control and discretion that persons other than the transferor have over the transferred assets.

The other attack consistently mounted by creditors when confronted with asset protection planning is that the transfer, if made, was a "fraudulent conveyance." The term "fraudulent conveyance" is defined differently from jurisdiction to jurisdiction. It also has a precise definition

Robert E. Ward, J.D., LL.M. (Taxation), is the sole stockholder of Robert E. Ward and Associates, P.C. located in Bethesda, Maryland. He is an adjunct faculty member at George Mason University School of Law and a member of the Maryland, California, and Washington State Bar Associations. *Copyright © 2000 by Robert E. Ward and Associates, P.C.*

under the Bankruptcy Code. Two concepts, however, are inherent in most fraudulent conveyance statutes that reflect both an objective and subjective test to determine if a fraudulent conveyance has occurred. If a transfer is characterized as a fraudulent conveyance under either test, the transfer is ineffective to put assets beyond the reach of the transferor's creditors. (See the sidebar on page 16 for a list of jurisdictions that have adopted the Uniform Fraudulent Conveyance Act and Uniform Fraudulent Transfer Act.)

Courts look to certain 'badges of fraud' to determine the intent that accompanies any particular transfer.

On an objective basis, any transfer will be characterized as a fraudulent conveyance if it renders the transferor insolvent. Generally, insolvency is defined by measuring the fair market value of the transferor's assets (immediately after the transfer) against the total liabilities of the transferor (also determined immediately after the transfer). Insolvency also exists if the transfer renders the transferor unable to meet the transferor's current obligations as they become due.

The subjective test is determined based on the intent of the transferor. If a transfer is made with the intent to hinder, delay, or defraud creditors, the transfer will be characterized as a fraudulent conveyance. Courts look to certain "badges of fraud" to determine the intent that accompanies any particular transfer. Commonly identified badges of fraud include:

1. Retention of an interest in the transferred property by the transferor.
2. Transfer between family members for previously existing debts.
3. Pursuit of the transferor or threat of litigation by the transferor's creditors at the time the transfer is made.
4. Lack of, or gross inadequacy of, consideration for the transfer.
5. Retention of possession of the property by the transferor.
6. Fraudulent incurrence of indebtedness after the transfer.
7. Secrecy about the transfer.
8. Deviation from normal activities.
9. Transfer of all (or substantially all) of the transferor's property.
10. Transfer to family members.

Any asset protection planning transaction must be scrutinized from the perspective that the transferor's present and future creditors will contend that no transfer has, in fact, been made and if made, the transfer was a fraudulent conveyance.

The following asset protection planning techniques are presented in order of ease of implementation. Successful use of any technique will require anticipating the probable theories of attack discussed above.

Ownership of Assets with a Spouse as Tenants by the Entirety

Most husbands and wives own at least some assets as tenants by the entirety. Many husbands and wives (particularly if married for a substantial length of time) own substantially all of their assets as tenants by the entirety. Some states presume a tenancy by the entirety to exist whenever assets are owned concurrently by both husband and wife unless the documents evidencing ownership state otherwise.

A tenancy by the entirety has many attributes. The attribute that is important for asset protection planning is that assets owned by a husband and wife as tenants by the entirety are not subject to the claims of creditors of either spouse. Instead, only a person to whom both spouses are obligated can assert claims against assets owned as tenants by the entirety. (Proceeds from the sale of property held as tenants by the entirety will typically retain their character unless

invested by the spouses separately or in some other form of co-ownership.)

Advantages. Several advantages are associated with a tenancy by the entirety.

1. The primary advantage of a tenancy by the entirety is the ease with which it is formed. Documents evidencing ownership (for example, a deed in the case of real property, a certificate of title in the case of a vehicle, or deposit agreements and related documentation in the case of bank and brokerage accounts) typically reflect the names of both the husband and wife followed by the phrase "tenants by the entirety."
2. The transferor continues as a co-owner of the assets held with the transferor's spouse as tenants by the entirety.
3. This is the simplest, easiest, and most effective form of asset protection attainable.

Disadvantages. Despite its effectiveness, a tenancy by the entirety brings with it certain disadvantages and limitations in use.

1. "You better love your wife/husband; your wife/husband better love you." For persons who have less than perfect relationships with their spouses, a tenancy by the entirety is not a viable planning technique.
2. A feature that distinguishes a tenancy by the entirety from other forms of co-ownership is that at the death of the first spouse to die, the survivor instantaneously and immediately becomes the sole owner of the entire asset.
3. Although one spouse can create a tenancy by the entirety, once created, the tenancy by the entirety can be terminated only with the consent of both spouses.
4. A tenancy by the entirety is obviously not an effective asset protection device for debt or claim with respect to which both spouses are co-obligors.
5. Tenancies by the entirety are not recognized in 29 U.S. jurisdictions.

Observation. Asset protection benefits notwithstanding, generally, tenancies by the entirety are to be avoided for both estate tax considerations and other asset protection issues.

Estate Tax Planning. For husbands and wives with even modest assets, ownership of assets as tenants by the entirety dramatically increases the federal estate taxes imposed on the transfer of assets to children. Understanding this result requires an awareness of the way in which the federal estate taxes are imposed and minimized. Not only do state and federal governments tax their residents each year on the income that they earn, but if there is anything left over at death, there will be a separate tax imposed on the transfer of wealth at the time of death. Federal estate taxes are imposed on the fair market value of assets owned by a decedent at the time of death. The decedent's taxable estate extends well beyond the assets that many persons consider themselves as owning to include, for example, death benefits payable under policies of insurance owned by the decedent, as well as the decedent's interest in pension and profit sharing plans and individual retirement accounts. Although federal income taxes are imposed at a maximum rate of 39.6%, federal estate taxes are imposed at a minimum rate of 37% with marginal rates reaching as much as 60%.

Federal estate taxes are avoided through effective use of the unified credit. Every taxpayer has a tax credit that will enable the taxpayer to avoid (for decedents dying in 2000) any federal estate tax on $675,000 in assets (the "applicable credit amount"). The applicable credit amount will increase until 2006 when it will reach a ceiling of $1 million. Under current law, increases after 2006 will be limited to modest increases based on increases in the consumer price index.

Every person has an applicable credit amount of $675,000. Consequently, a husband and wife have the capacity to transfer a total of $1.35 million to $2 million in assets without payment of any federal estate tax (depending on the year in which deaths occur). If, however, at the death of the first spouse, everything passes to the surviving spouse (whether because assets are owned as tenants by the entirety or because of the directions in the first spouse to die's will), the first spouse to die's unified credit is forfeited. Consequently, the wealth that can be transferred tax free to their children is cut in half.

Asset Protection Planning for the Surviving Spouse. The second reason why tenancies by the entirety are disfavored is the elimination of opportunities that should properly be used to protect assets received by a surviving spouse at the death of the first spouse to die. Assets that are owned as tenants by the entirety pass directly to the surviving spouse at the death of the first spouse to die. In contrast, assets that are owned by a deceased spouse that are intended to benefit the surviving spouse, are better diverted to a trust for the benefit of the surviving spouse because of the protection the trust will provide from the following three significant life hazards.

1. Divorce.
2. Death.
3. Litigation.

Assets that are inherited by a surviving spouse at the death of the first spouse to die become vulnerable if the survivor remarries. Although the inheritance will initially be characterized as separate property, the law tends to disfavor characterization of assets as separate property in favor of their characterization as marital property. Marital property is subject to division by a divorce court; separate property is not. Separate property will lose its character as separate property if it becomes commingled with marital property. Often, commingling occurs unintentionally, with the result that inherited assets are converted from separate property to marital property and, consequently, subject to division by a divorce court.

Careful attention and maintenance of inherited assets separate from marital assets will protect assets inherited by a surviving spouse at the death of the first spouse to die from marital claims arising in divorce. Segregation of separate property from marital property, however, will not protect assets from claims that can be asserted by a new spouse (if the surviving spouse remarries) at the surviving spouse's death in common law jurisdictions (that is, all U.S. jurisdictions that have not adopted community property statutes: the District of Columbia and all states other than California, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin).

In common law jurisdictions, the new spouse has a statutory right to claim a minimum share of the surviving spouse's estate. These statutory rights (often referred to as elective share rules) apply to all assets owned at death, including separate property acquired either before or during the marriage. Thus, when a surviving spouse remarries, even though the surviving spouse's will, for example, leaves all of the survivor's assets to the survivor's descendants, the new spouse can elect against the survivor's will and claim a statutory share of the surviving spouse's estate. The statutory share may be as little as 10% or as much as 50%, depending on the jurisdiction in which the surviving spouse either resides at the time of death or the jurisdiction in which the surviving spouse's assets are located. For example, the elective share in Virginia, Maryland, and the District of Columbia is one-third.

Even if the surviving spouse never remarries, the assets inherited at the death of the first spouse to die are vulnerable to claims of the surviving spouse's creditors. Creditors' claims can arise in a variety of

contexts: automobile accidents, professional negligence, civil and criminal penalties arising from illegal activities, as well as credit transactions.

Gifts Using Domestic Trusts

With the same simplicity as creation of a joint tenancy, equivalent asset protection can also be achieved by making a gift. Unless attacked as a fraudulent conveyance, a gift is effective to place assets beyond the reach of creditors. For a variety of reasons, however, the transferor may be reluctant to make gifts directly to the recipient.

- The transferor loses control of the transferred property.
- Direct gifts become vulnerable to the same life hazards articulated above with respect to direct transfers to a surviving spouse: divorce, death, or litigation.

The disadvantages of direct gifts are avoided through the use of a trust. A trust is simply an arrangement whereby one person (trustee) holds assets for the benefit of another (beneficiary). The trust agreement describes the duties of the trustee, identifies the beneficiaries, and instructs the trustee how to use the trust assets for the benefit of the beneficiaries. The trust may be established either in the U.S. (a domestic trust) or under the laws of a non-U.S. jurisdiction (a foreign trust).

Use of a domestic trust protects the assets that are transferred from claims that could be asserted by spouses or creditors of the beneficiaries and allows the grantor to exert direct or indirect control over the trust property. Control can be asserted indirectly through selection (and removal) of trustees (other than the transferor). Control can also be asserted directly if the grantor assumes the position of trustee. As explained above, however, the grantor's involvement as trustee clearly invites scrutiny as to whether, in fact, a transfer has occurred.

To be effective as an asset protection device, the domestic trust must be irrevocable and the grantor generally cannot be a beneficiary. Most U.S. jurisdictions follow the Restatement of Trusts, which provides that creditors of a transferor can reach assets transferred to a trust with respect to which the transferor is a beneficiary (even if only one of many beneficiaries). This result applies even if the transferor is not acting as the trustee.

Unless attacked as a fraudulent conveyance, a gift is effective to place assets beyond the reach of creditors.

Advantages. Several advantages are associated with the use of a domestic trust as an asset protection device.

1. Although more elaborate than a direct gift (including creating a tenancy by the entirety), formation of a domestic trust benefiting other members of the transferor's family remains a commonplace transaction typically used in connection with estate planning.
2. The transferor is able to continue to exert control over the assets transferred to the domestic trust through selection of an appropriate trustee and by design of the provisions of the trust agreement, which instruct the trustee as to the circumstances and uses of the trust assets.
3. Assets transferred to a domestic trust will typically not be included as part of the transferor's taxable estate, consequently complementing the transferor's estate planning and effective transmission of wealth to surviving family members in a tax-effective manner.

Example. Shares of stock in a start-up business are transferred to an irrevocable domestic trust designating the transferor's spouse as trustee. The trustee is directed to accumulate and invest the trust assets, making no distributions to any beneficiaries until after the transferor's death occurs. After the transferor's death, the trustee is instructed to use the trust assets

to provide for the transferor's spouse's and children's health, support, education, and maintenance, distributing whatever amount of income or principal is necessary for these purposes. The start-up eventually goes public. The assets held by the domestic trust multiply a hundredfold. The trustee invests a portion of the trust assets in a new start-up enterprise (either as debt or equity) in which the transferor also participates as a stockholder. The new enterprise employs the transferor and provides certain fringe benefits (including establishing a tax-qualified pension or profit-sharing plan). Ultimately, (perhaps at the transferor's retirement) the new business is sold, with the trust receiving an appropriate portion of the sales proceeds based on its interest (debt or equity) in the new company.

Legal fees for establishing a foreign trust are five to ten times the cost of establishing a comparable domestic trust.

As the example illustrates, the domestic trust really serves as a private bank to support the transferor's continued financial endeavors. Although the transferor is not a beneficiary and has no control over the trust assets (inasmuch as the transferor is not acting as trustee), the arrangement is nonetheless quite accommodating.

Disadvantages. Among the domestic trust's disadvantages are the following:

1. The transferor loses direct control over the assets that are transferred to the domestic trust.
2. The transfer of assets to the domestic trust is irrevocable.
3. The domestic trust becomes a separate tax-paying entity.
4. Due to the irrevocable nature of the domestic trust, careful consideration has to be given to its provisions.
5. A transfer of assets to the domestic trust will be a taxable gift (although not necessarily a gift with respect to which any gift tax liability will be paid at the time of formation), which requires preparing and filing a Form 709 Federal Gift Tax Return.

Foreign Asset Protection Trusts

The most elaborate form of asset protection planning is to use a foreign asset protection trust. Due largely to the influence of the local banking community in various jurisdictions around the world, many governments have enacted laws that are intended to protect and encourage non-citizens of these jurisdictions to establish financial accounts or fiduciary relationships with institutions located in those jurisdictions. There are three to four dozen jurisdictions around the world that have made serious attempts to attract foreign capital by adopting bank secrecy and asset protection laws.

The following criteria are useful in selecting an appropriate jurisdiction for establishing foreign asset protection trusts.

1. Favorable and stable economic, political, and social environment.
2. Absence of local taxes.
3. English-speaking jurisdiction.
4. Availability of professional services.
5. Relatively contiguous time zone.
6. Availability of modern telecommunications facilities.
7. Favorable trust law, including the following provisions:

- Non-recognition of foreign judgments (comity).
- The jurisdiction's courts will apply only local law with respect to administration of trusts domiciled in that jurisdiction.
- Local law clearly defines what powers and benefits may be retained by the grantor without subjecting assets of the foreign trust to attachment by creditors of the grantor.
- The jurisdiction has clearly defined fraudulent conveyance laws.
- The jurisdiction has clearly defined statutes of limitations.

- Statutes of limitations for creditor's claims run from the date assets are transferred to the trust (not the date the creditor's claim arises or the date the creditor becomes aware of the transfer).

Advantages. Anything that can be accomplished through a domestic trust can also be accomplished through a foreign trust. Foreign trusts are, however, responsive to certain disadvantages associated with domestic trusts (and other alternative asset protection techniques), as well as offering certain additional advantages.

1. The most significant advantage provided by a foreign asset protection trust is that it enables the grantor to continue to benefit from the assets transferred to the trust by designation of the grantor as a beneficiary. This is the feature that distinguishes foreign trusts from any of the other preceding asset protection alternatives and provides a compelling advantage to their use.
2. The trust can become a vehicle for global investing, providing financial opportunities otherwise not available to investors resident in the U.S.
3. The trust will avoid potential monetary exchange controls.

Disadvantages. The following are among the disadvantages associated with the use of a foreign trust.

1. Legal fees for establishing a foreign trust are five to ten times the cost of establishing a comparable domestic trust.
2. The grantor of the trust cannot act as trustee and should be cautious in undertaking any direct contact with the foreign trustee.
3. The security provided by intense government regulation of the financial industry and the services it provides is not as omnipresent in most foreign jurisdictions as it is in the U.S.
4. The grantor of a foreign trust remains taxable for U.S. income tax purposes on all income produced by the trust assets.
5. Grantors and beneficiaries of foreign trusts are subject to substantial U.S. reporting requirements, including Treasury Department Form 90-22.1 (Report of Foreign Banking and Financial Accounts), Form SS-4 (Application for Employer Identification Number), Form 56 (Notice of Fiduciary Relationship), Form 3520 (Notice of Creation of or Transfer to Certain Foreign Trusts), and Form 3520A (Annual Report of Foreign Trust with U.S. Owner).
6. There is a necessity for strict attention to detail.
7. A sophisticated or well-advised creditor will not attempt to chase assets that have been transferred offshore. Instead, the creditor will attack the transaction in the U.S. courts as either a fraudulent conveyance or an incomplete transfer and, by arguing the "equities" of the case and the "abusiveness" of the transferor's conduct, attempt to persuade the U.S. courts to hold the transferor in contempt until the assets are repatriated to the jurisdiction of the U.S. courts.
8. It is sometimes difficult to find an appropriate trustee. A financial institution with branches in the U.S. is inappropriate to act as trustee of a foreign trust inasmuch as the trustee's own assets become vulnerable to actions that may be taken by the U.S. courts.

Observations. For clients who are interested in the greatest amount of asset protection without the loss of direct financial benefit from the protected assets, the foreign asset protection trust is the superior alternative. No other arrangement creates such significant roadblocks to a creditor's access to the transferred assets without depriving the transferor of opportunities for direct financial benefit. Further, the author is unaware of any decision in which

Uniform Fraudulent Conveyance Act and Uniform Fraudulent Transfer Act

Jurisdictions adopting versions of the Uniform Fraudulent Conveyance Act (UFCA) include Delaware, Maryland, Massachusetts, New York, Tennessee and Wyoming.*

Jurisdictions adopting versions of the Uniform Fraudulent Transfer Act (UFTA) include Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Hawaii, Idaho, Illinois, Maine, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Texas, Utah, Washington, West Virginia and Wisconsin.**

* See generally, Wolf, "Understanding the Uniform Fraudulent Conveyance Act and its Application in Creditor Attacks," 1 JOAP 34 (March/April 1996).

** See generally, Wolf, "Understanding the Uniform Fraudulent Transfer Act and its Application in Creditor Attacks," 1 JOAP 38 (Sept/Oct 1995).

a creditor has been successful in attacking a foreign asset protection trust when the trust was properly established and administered with the necessary attention to detail. There are, however, many cases where creditors have been successful in attacking this planning when the necessary attention to detail was lacking. Problems are most often created when transferors have:

- Not complied with U.S. tax laws in their failure to disclose establishment of the foreign trust and transfer of assets to it or to report the income from the transferred property.
- Continued direct involvement in the administration of the trust assets.
- Participated in a fraudulent conveyance.
- Engaged in conduct so abusive in their financial dealings so as to compel the U.S. court to reach a result-oriented decision, ignoring the status of the trust as an entity separate and apart from the transferor.

Alaska Asset Protection Trust

As an alternative to establishing a trust in a foreign jurisdiction, the 1997 Alaska Trust Act offers a domestic alternative to foreign asset protection trusts. The purpose of the 1997 Alaska Trust Act is to offer a domestic alternative that allows the transferor to protect assets from the transferor's creditors while remaining a beneficiary of the Alaskan trust. While on its face promising, the Alaska asset protection trust remains untested. The most significant concern is comity. Because Alaska is one of the American states, its courts will be required to give full faith and credit to any judgment of another U.S. jurisdiction even though a judgment would not be obtainable in Alaska against the trust assets. Comity arises under the full faith and credit clause of the U.S. Constitution. Obviously, the advantage of a foreign asset protection trust is that the courts of a foreign jurisdiction are not required to give comity to the decisions of the U.S. courts.

Conclusion

Clients place a high value on simplicity. Simplicity, for many reasons, often has a direct relationship to success. Consequently, the simplest asset protection alternatives should be used to the

extent they prove sufficient to accomplish the client's goals. If, for whatever reason, one alternative is inadequate or inappropriate, move to the next in the order presented in this article until arriving at the last alternative. The last alternative, although in many ways the best, is expensive, complex, and will be effective only if administered properly.

Finally, never do anything that cannot be explained to a judge with a straight face. If claims or liabilities already exist, it is too late to do the asset protection planning described above. Asset transfers to defraud existing creditors do not predispose a judge to rule favorably on behalf of a debtor. The more complicated the planning, the more opaque the design, the greater the hostility that is likely to be engendered. Asset protection planning should be done early, carefully, and with a large element of common sense. ■