The Tools of Domestic and International Asset Protection

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How Do You Know Whether a Client Needs an Asset Protection Vehicle?

- Every client needs asset protection to some degree
- The greater the client’s net worth the more difficult it is to achieve asset protection without a protective trust or entity structure

Asset Protection Needs Analysis

- Is the client in a high risk profession? (doctor, lawyer, accountant, securities industry, etc.)
- Does the client serve in a high risk capacity? (director or officer of public company, director of public or private charity, etc.)
- Does the client own high risk assets? (real estate, airplane, original issue stock in a public company, etc.)

Asset Protection Needs Analysis (cont.)

- Does the client have a high profile? (entertainer, politician, musician, sports figure, etc.)
- Does the client have a history of being involved in litigation?
- Does the client live, own assets, or own businesses in volatile or unstable countries? (e.g., China, Colombia, Haiti, Mexico, etc.)

Asset Protection Needs Analysis (cont.)

- Does the client own intellectual property? (trademarks, patents, copyrights, domain names, etc.)
- Does the client manufacture, distribute, or market products that tend to either cause harm or are liable to fail to protect against harm? (e.g., body armor, prescription drugs, etc.)
- Is the client unable to fully insure against foreseeable business and personal risks?

Isn't Asset Protection Against Public Policy?

"[T]he 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."[1]

[1] Nichols v. Eaton, 91 U.S. 716, 725-726 (1875) (Justice Samuel Freeman Miller).

United States Legal System

The U.S. legal system is different from other Western legal systems in many important ways.

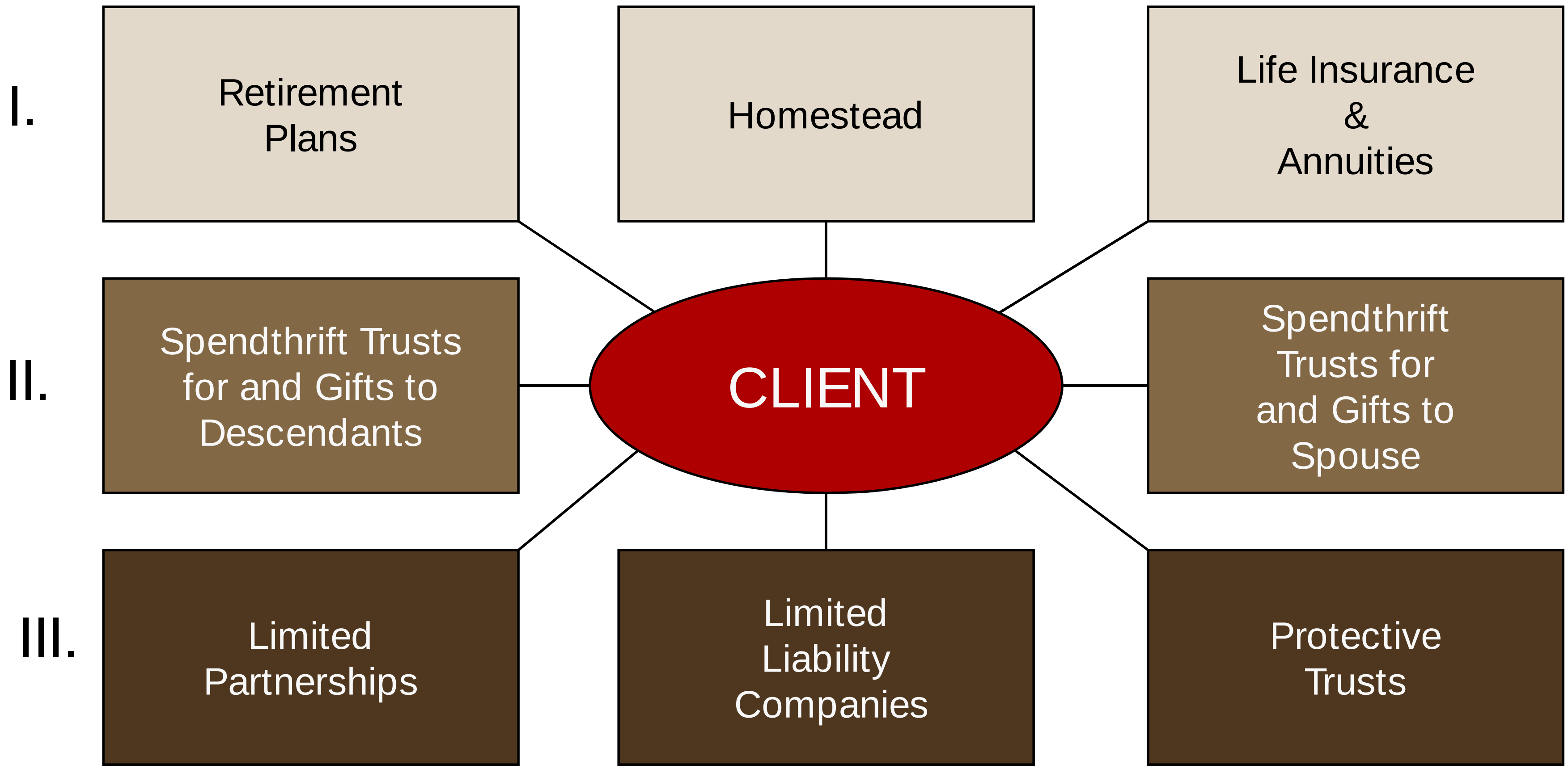
- Contingency fees allowed
- Pleadings are protected speech
- Punitive damages are allowed in civil cases against individuals (rather than only in cases involving corporate products liability)
- There is no bond requirement, except for appeals
- There is no loser–pay system
- Regulatory “Super Creditors” pose additional risks

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

- Expands list of nondischargeable consumer debt
- Amends means test so that, in general, debtors with income greater than state median household income can not get discharge and will be required to reorganize

Asset Protection
Methods & Structures

Methods to Achieve Asset Protection



Creditor Protection: Fraudulent Transfer Law

- General rule
  - A gratuitous transfer of property with the actual or constructive INTENT to avoid creditors is fraudulent and may be set aside by creditors
  - Any transfer of assets from nonexempt status to exempt status should be tested to assure that it is not a fraudulent transfer
- Three classes of creditors
  - Present creditor – solvency analysis
  - Potential subsequent creditor – badges of fraud
  - Unknown future creditor

Creditor Protection: Fraudulent Transfer Law (cont.)

- Statute of limitations
  - Statute of limitations on fraudulent transfer claims in most states is four years from the transfer, or, for existing creditors, within one year of when the transfer could reasonably have been discovered, if later
  - 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

Solvency Test

	Total value of assets
Less:	Liabilities (including contingent)
Less:	Creditor protected assets (e.g., homestead)
Equals:	Amount that can be transferred

Retirement Plans

- In most states, unlimited exemption as long as the plan "qualifies" under the Internal Revenue Code
- ERISA contains anti-alienation provisions
- Fully protected in bankruptcy if they are exempt from taxation under IRC §§401, 403, 414, 457, or 501(a)
- Protection for IRAs (under IRC §§408 and 408A) in bankruptcy capped at $1,000,000 adjusted for inflation (currently $1,245,475)
- Rollover amounts to IRAs are excluded from bankruptcy cap

Homestead

- State homestead exemptions based upon either acreage (for example, Florida, Texas, and Kansas) or value (for example, California and Missouri)
- 2005 Bankruptcy Act Amendment possibly limits equity obtained in homestead during 40 months prior to bankruptcy to $125,000 adjusted for inflation (currently $155,675)

Life Insurance and Annuities

- Many states exempt cash value and policy proceeds of life insurance and annuities, even if the insured retains the power to change the beneficiary or the insured or the insured's estate is a contingent beneficiary
- 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

Life Insurance is also a Tax Efficient Investment

- Earnings (dividends, interest, and capital gains) are income tax free to policyowner
- Withdrawals and policy loans used to access policy cash values during lifetime are income tax free (with proper structure)
- Death benefit received by beneficiary is income tax free

Section 529 Plans

- Some states exempt the assets held in §529 plans if the debtor resides in that state and the plan assets are held by that state's authorized plan
- Other states, like Texas, exempt the plan assets regardless of where the assets are held as long as they are held in a state qualified tuition program that meets the requirements of IRC §529

Section 529 Plans (cont.)

- Bankruptcy Code exempts funds in §529 plans but generally limits the exemption to the contribution limits contained in §529 and specifically limits the exemption by completely disallowing contributions made 1 year before bankruptcy and only exempting contributions that do not exceed $5,000 per beneficiary that were made between 2 years and 1 year before bankruptcy

- In states that allow debtors to choose state rather than federal bankruptcy exemptions §529 plans may be fully exempt in bankruptcy

What is a Spendthrift Trust?

A spendthrift trust is one in which the beneficiary is precluded or restrained from voluntary or involuntary transfers of trust assets. In some states, this includes a prohibition on the ability to pledge as collateral any interest in a trust. The consequences of these types of provisions in trust documents is that the beneficiary's creditors are precluded from reaching trust assets. In most states, settlors cannot utilize a spendthrift trust to protect assets from the settlor's creditors.

Spendthrift Trusts

- Primarily statutorily created – not a part of English common law
- Some states have no spendthrift statutes, but judicial decisions have validated spendthrift provisions (Hawaii, Maryland, Massachusetts, Michigan, Minnesota, and Vermont)
- Uniform Trust Code 2000 contains provisions validating spendthrift provisions in trusts and addressing rights of settlor’s creditors

Trusts for Family Members With Spendthrift Protection

- Trusts for Descendants
  - *Crummey* Trust
    - $14,000 per donee annual exclusion possible
  - §2503(c) Trust
    - Contributions to trusts for children under age 21 are not gifts of a future interest
  - Life insurance trust
- Inter vivos QTIP after partition
  - All income to spouse required, but document can disallow distribution of principal on the happening of some event like divorce

Charitable Planning

- Certain charitable gifts protect assets as well
  - Gift of home to a qualified charity with a retained life estate
  - Bargain sale to a qualified charity
  - Charitable Lead Trust
  - Charitable Remainder Trust

Limited Partnerships and Limited Liability Companies

- Aggregate Theory (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.)

- Entity Theory (current view)
  - The partnership is a distinct legal entity separate from its partners
  - Partners do not own a interest in partnership property; instead, they own an interest in the entity
  - 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 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 corporations (NRS §78.746)

Charging Order

A charging order is an order issued by a court pursuant to statute which charges the debtor's interest in the entity with the amount due to the judgment creditor. Under a charging order, the creditor only gets distributions from the entity to the extent of the debt. Once the debt is extinguished, the charging order is fulfilled. The debtor's interest in the underlying partnership or company assets is preserved.

Foreclosure

If a creditor's lien on a debtor's interest in a partnership is foreclosed upon, the debtor loses the partnership interest and all of the future benefit in that interest forever (even if that benefit greatly exceeds the debt) including a right to that partner's pro rata share of the new assets at liquidation (The Uniform Limited Partnership Act (2001) §702(b)). In addition, upon foreclosure, the debtor-partner may also lose the managerial rights afforded him by §702(b) if the other partners consent to expel him in accordance with §601(b)(4). Depending on the relationship with the other partners, this could be incentive for the partner to settle with the creditor instead of forcing a settlement the other way around.

Foreclosure (cont.)

- 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
- 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

Limited Partnerships

- Limited partners liable for partnership liabilities only to extent of contribution to partnership
- Partner’s interest protected from unrelated judgment creditors
- Helpful planning tools but it is important to understand their limitations

Limited Liability Companies

- Limited liability vehicles should be used to contain liability to the extent of contribution to the entity
- Multiple limited liability companies may be used to sequester liability exposure
- Corporate formalities must be followed
- Taxed as a disregard if there is a single owner and as a partnership if there are multiple owners

Advanced Strategies

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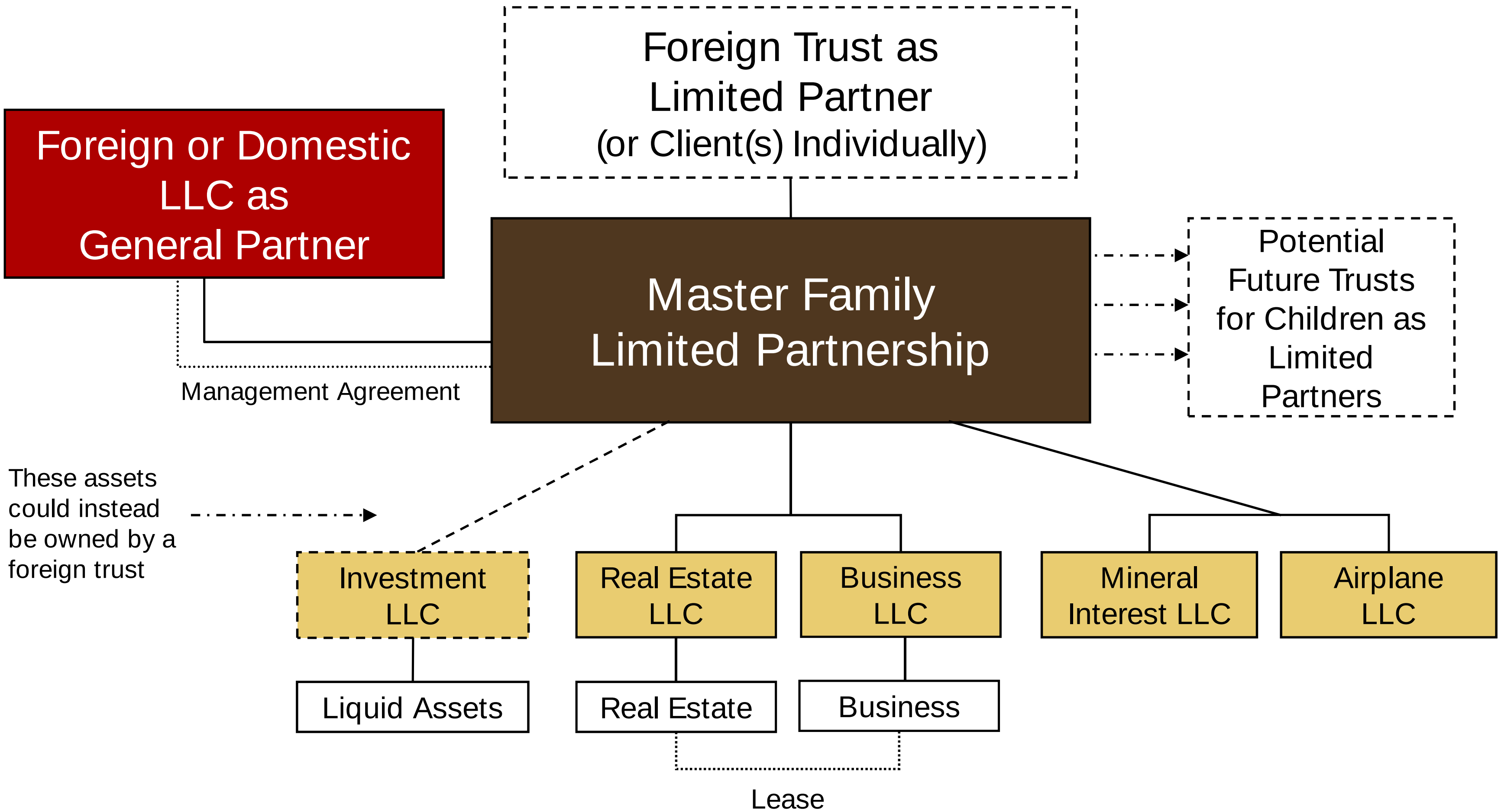
Master Family Limited Partnership Structure



What is a Protective 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

Protective Trusts –
Two Very Different Options

- Domestic
  - Available in Delaware (1997), Alaska (1998), Nevada (1999), Rhode Island (1999), Utah (2003), South Dakota (2005), Tennessee (2007), Wyoming (2007), New Hampshire (2008), Hawaii (2010), and to a lesser extent, Colorado (1994),* Oklahoma (2004), and Missouri (2005), Virginia (2012), Ohio (2013), and Mississippi (2014).
- Foreign
  - Available in many foreign countries

Vulnerabilities of Domestic Protective Trusts

- Access to trust assets through U.S. court system
- U.S. Constitution
- Availability of punitive damages and attorney's fees

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

Offshore Protective Trusts Offer Additional Benefits (cont.)

- Punitive damages and contingent fee contracts not allowed
- Secrecy and privacy laws prevalent and strictly enforced

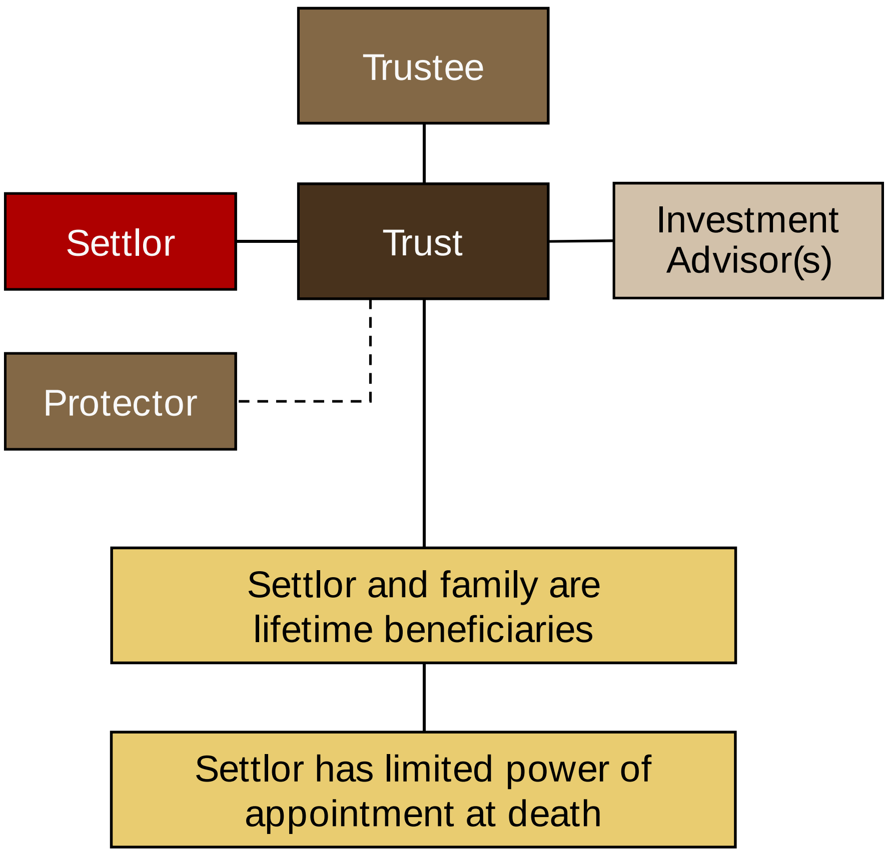
When To Settle a Protective Trust

- Before Insolvency
  - Cannot make a fraudulent transfer under state law or bankruptcy law – a 10–year clawback period may apply in bankruptcy
  - A gratuitous transfer of property with the actual or constructive INTENT to avoid creditors is fraudulent
- Before a claim arises
  - Greater distance in time between transfer and claim against assets results in superior protection

Control and Contacts

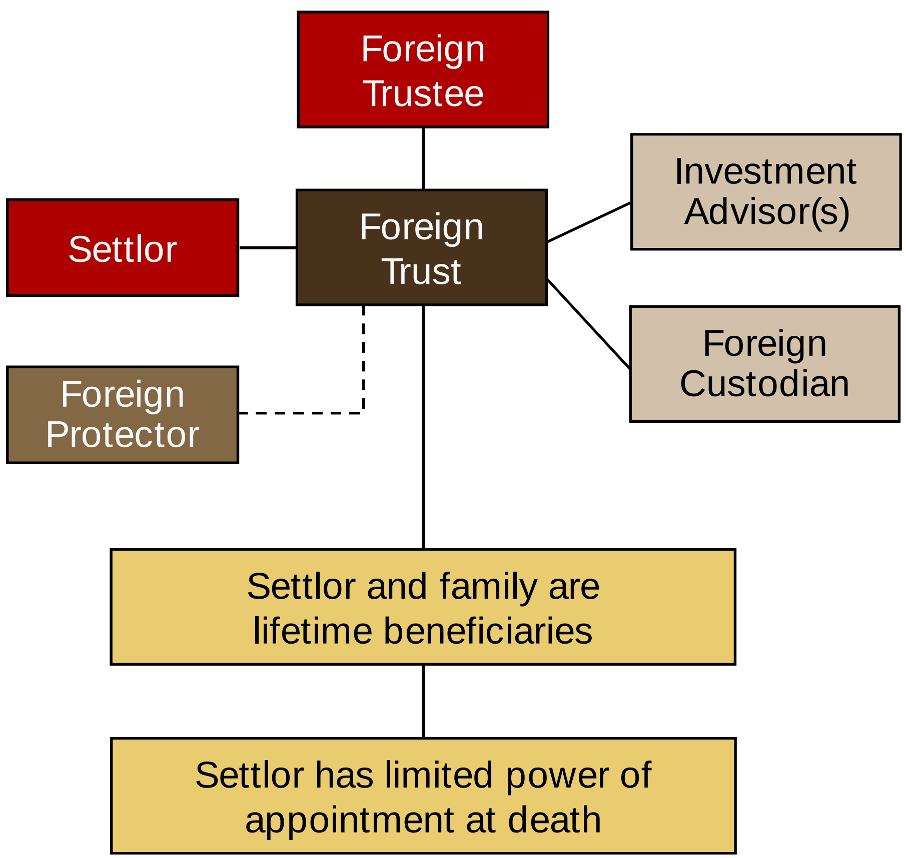
Less Asset Protection	More Asset Protection
Greater Settlor control	Less Settlor control
More U.S. contacts	Few or no U.S. contacts

Typical Protective Trust Structure (Domestic)



- Wholly discretionary (rather than ascertainable) distribution standard
- Trustee can add and remove beneficiaries
- Redomiciliation permitted

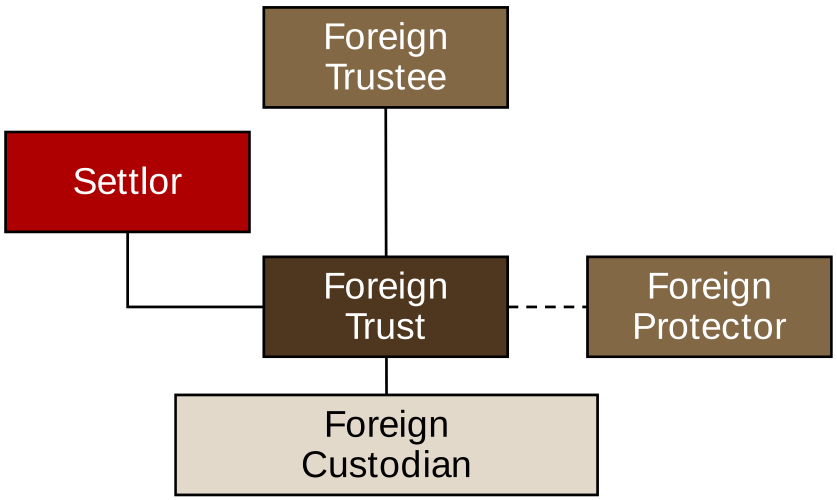
Typical Protective Trust Structure (Foreign)



- Wholly discretionary (rather than ascertainable) distribution standard
- Trustee can add and remove beneficiaries
- Redomiciliation permitted
- Independent investment advice the norm

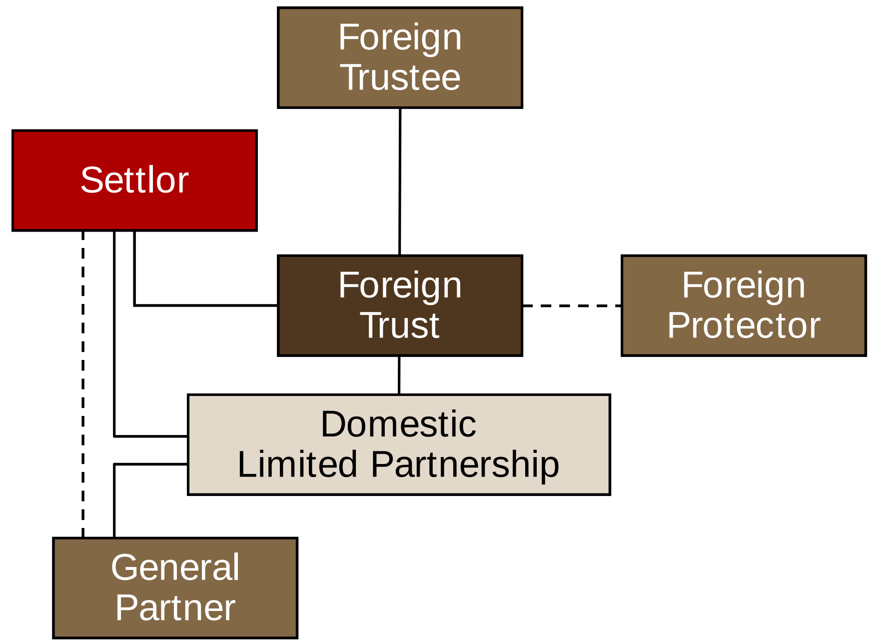
Two Fundamentally Different Offshore Strategies

EXPORT THE ASSETS



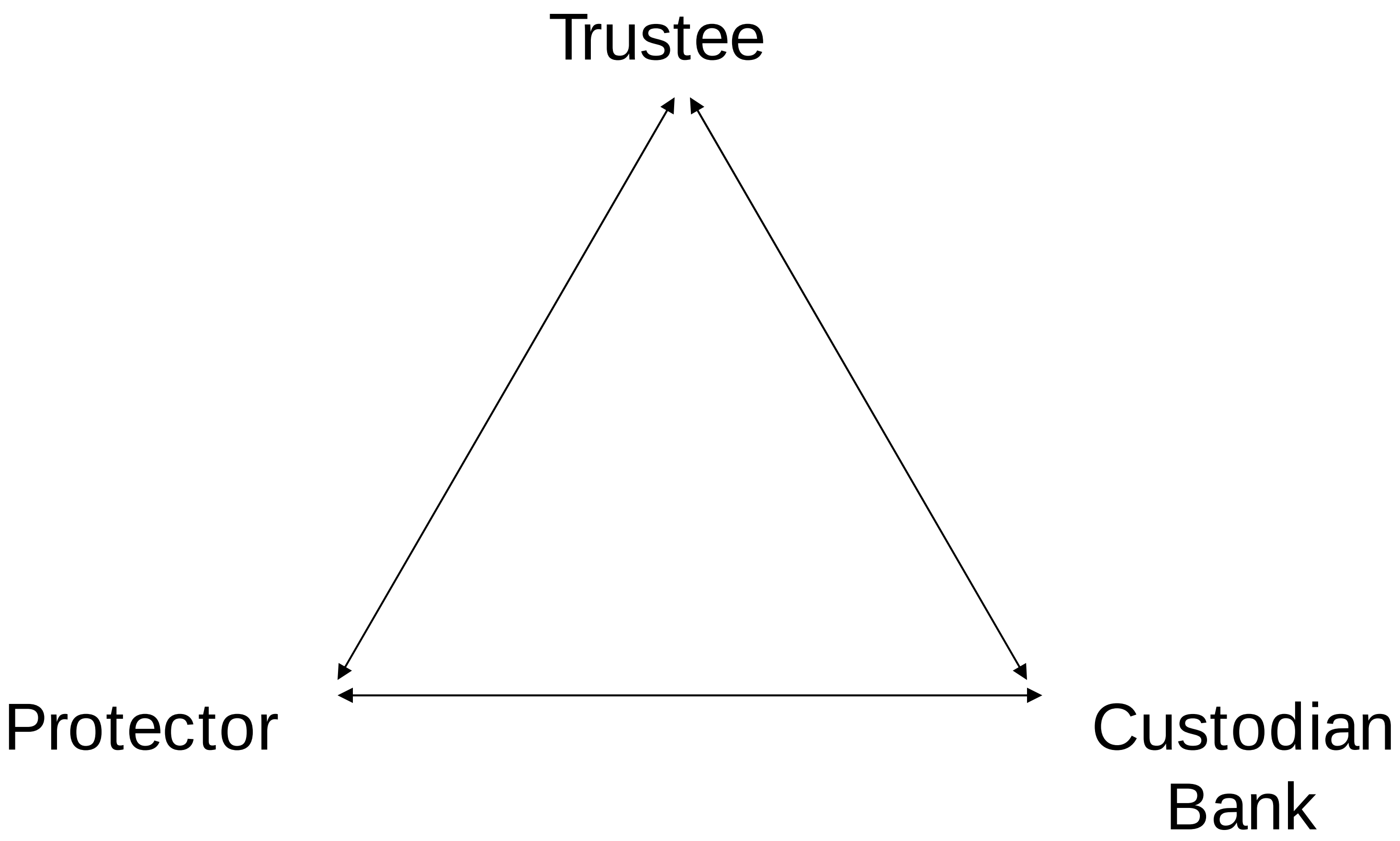
JURISDICTIONALLY SEVERED

IMPORT THE LAW



JURISDICTIONALLY CONNECTED

Check and Balance System



Representative Trust Structures

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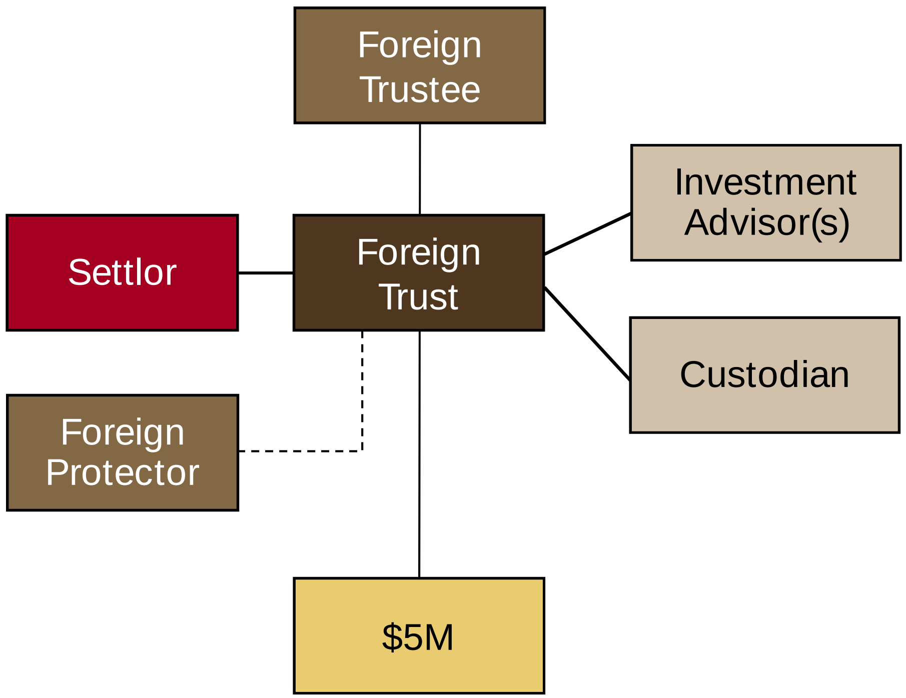
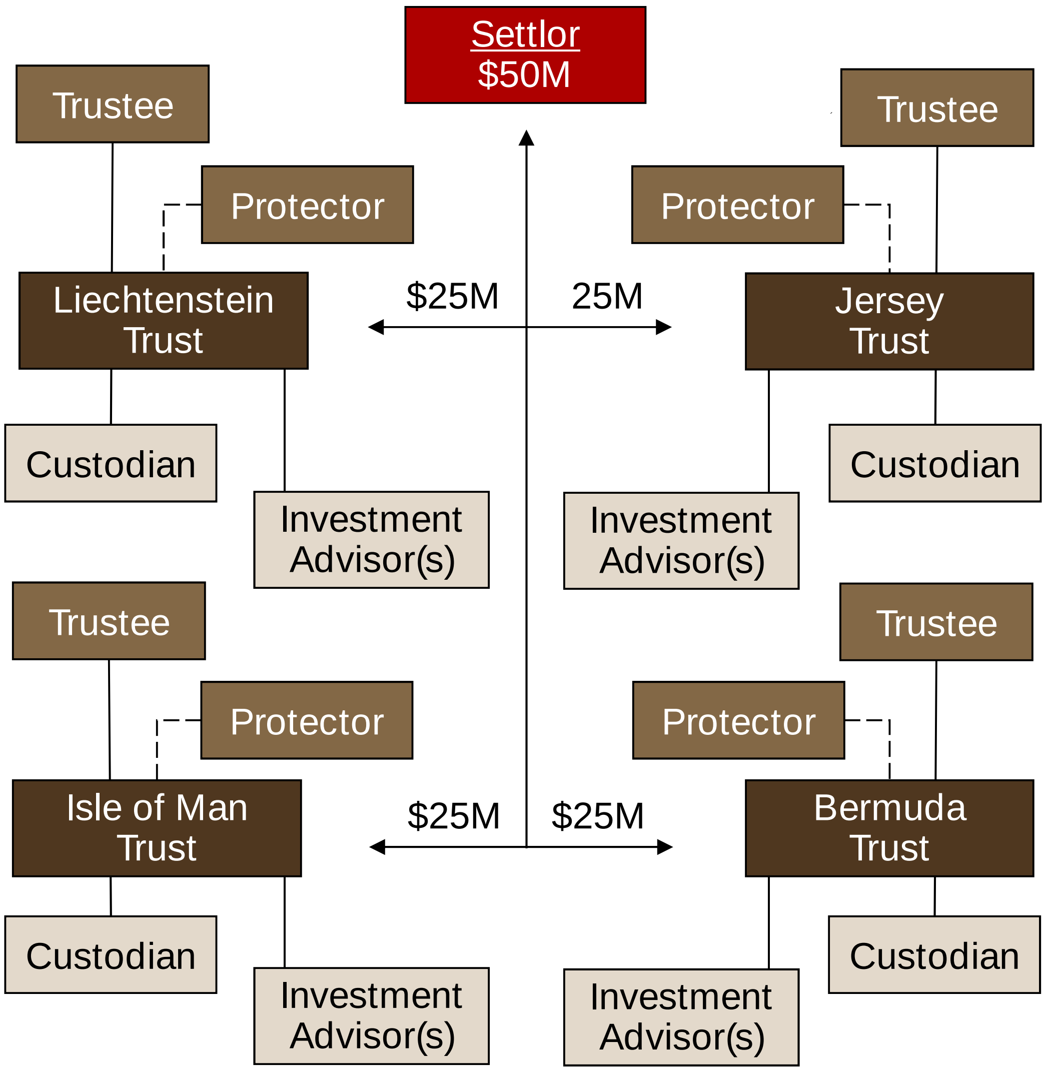
Nest Egg Trust



EXAMPLE

- 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

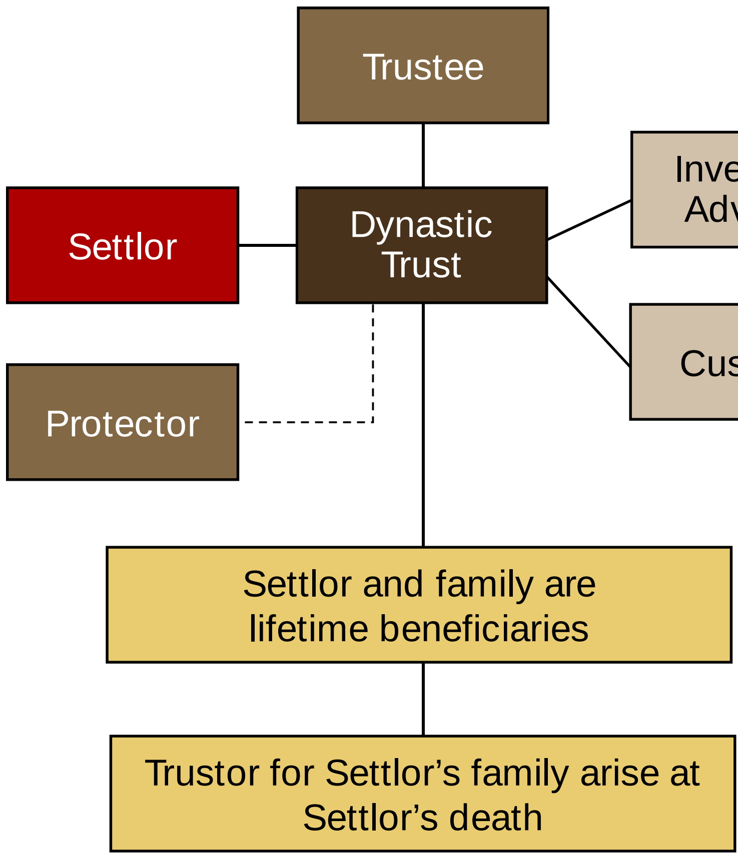
Multiple Trusts



EXAMPLE

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

Domestic or Foreign Dynastic Trust

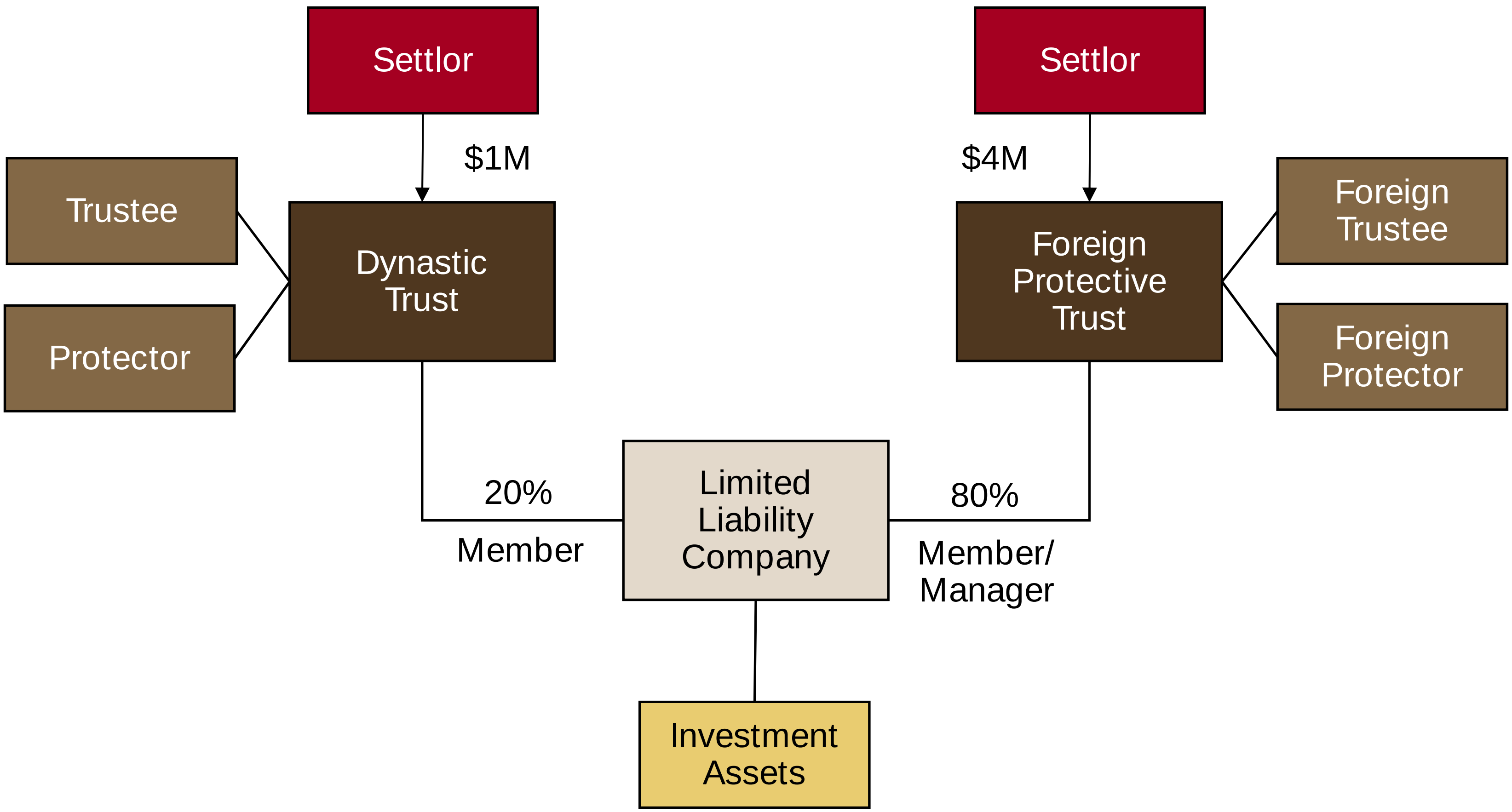


- All of the benefits of a basic wealth protection trust, including Settlor's retention of beneficial interest

  and

- Settlor can make a completed gift (which might use exemption equivalent amount) and allocate GSTT exemption
- Assets may not be included in Settlor's estate for federal estate tax purposes
- Establish in jurisdiction where perpetual trusts are allowed
- Investment advice to Trustee may be provided by pre-selected investment consultant

Combination of Trust Structures



Trust Implementation

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Selection of Jurisdiction

- Traditional Jurisdictions
  - Jersey
  - Guernsey
  - Liechtenstein
  - Isle of Man
  - Bermuda

Selection of Jurisdiction (cont.)

- Established "Asset Protection" Jurisdictions
- Cayman Islands
- Bahamas
- Gibraltar
- Belize

Selection of Jurisdiction (cont.)

- 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

Liechtenstein (cont.)

- 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

Cook Islands (cont.)

- 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

Negotiation of Fees

- Start-up
  - Legal fees
  - Trustee fees
  - Foreign taxes/duties
- On-going
  - Legal fees
  - Accounting fees
  - Trustee fees
  - Protector fees
  - Custodial fees
  - Money management fees
  - Foreign taxes

Due Diligence (Standard for all Jurisdictions)

- Certified copies of settlor's passport and residential utility bill
  - In some jurisdictions, the same is required of all current beneficiaries
- Letter of recommendation from attorney or bank
- Professional curriculum vitae for settlor, if applicable
- Statement as to source of wealth
- Financial statement (including current and contingent liabilities) accompanying an affidavit of solvency

Additional Due Diligence (Varies by Jurisdiction)

- Due diligence forms and additional requirements vary from jurisdiction to jurisdiction, but typically include:
  - Personal details for settlor and settlor's immediate family
  - Current occupation of settlor and business/career history (source of wealth)
  - Information on proposed trust structure, including name of trust, beneficiaries, protector, etc
  - Information on proposed trust funding, including source of funds, type and amount of assets to be contributed, and plans for future investment and handling of trust assets

Preparation of Documents

- Trust instrument
- Affidavit regarding financial condition
- Trustee and protector fee agreement letters
- Form SS-4: Application for Employer Identification Number
- Authorization of agent (IRS)
- Account opening documents (including Forms W9 and W-8IMY - withholding certificates)

Tax Considerations and Reporting Requirements

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Income Taxation – Typically Tax Neutral

- 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: IRC §684

- Incomplete Gift Trust: no tax on transfer of appreciated assets when trust is a Grantor Trust; no tax on appreciated assets at Grantor's death.

- Completed Gift Trust: no tax on transfer of appreciated assets when trust is a Grantor Trust; but tax is imposed on appreciated assets at Grantor's death.

Gift Taxation – Typically Tax Neutral

- Gift Tax: gifts can be either complete (gift tax due on transfers) or incomplete (no gift tax due on transfers); incomplete gift requires retention by grantor of special power of appointment

Estate Taxation – Typically Tax Neutral

- Estate Tax: assets not includible in estate for federal estate tax purposes if there was a completed gift made at time of transfer, but are included if there was an incomplete gift made at time of transfer

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)
- Form TD F 90-221.1: Report of Foreign Bank Accounts
- Form 8938: Statement of Foreign Financial Assets

Primary Foreign Trust Filing Requirements (cont.)

- Form 8858: Information Return of U.S. Persons with respect to Foreign Disregarded Entities
- TDF 90-22.1: Report of Foreign Bank and Financial Accounts
- Form 709: United States Gift (and Generation-Skipping Transfer) Tax Return

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