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SPECIAL REPORT:
Asset Protection Planning Guide

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What is Asset Protection Planning?

Asset protection planning is the application of various techniques to protect one's assets from future creditor claims. These techniques are designed to deter potential creditors from filing claims by frustrating or hindering the collection of judgments. The first step in asset protection planning is to conduct a risk analysis and to consider the likely litigation threats to your professional practice or business. How can you minimize these threats? What should you have in place if the threat becomes a reality and results in litigation? Tax and investment objectives must also be considered in determining which asset protection strategies to pursue.

THE PROBLEM

Business and professional people typically work for a long time and accumulate assets with hopes of benefiting themselves and their families during their careers and retirement. Unfortunately, we live in a litigious society and business and professional people have significant exposure to claims from creditors. They make good targets for creditor claims because of the activities in which they engage and because they have accumulated significant assets. There are steps available to protect assets from creditor claims if taken in a timely manner. It may be too late if an individual waits until a claim is already filed or an incident that may lead to a claim has already occurred before taking action. Many states have adopted the Fraudulent Transfer Act or alternatively penalize fraudulent transfers. This Special Report will discuss the strategies for asset protection from ranging simple to complex. These strategies include obtaining the proper insurance, proper titling of assets, retirement plans, structuring business assets, Domestic Asset Protection Trusts (DAPTs), and off-shore trusts. Finally, this report will also discuss whether an individual is a good candidate for asset protection planning.

STRATEGIES

There are a number of strategies available to protect assets ranging from quite simple to very complex.

The first basic tenet of asset protection planning is obtaining adequate insurance.

♦ **Auto, Home and Life Insurance.** Asset protection begins with obtaining the proper insurance for any given situation. Basic insurance includes automobile, homeowner's insurance, and life insurance. The purpose of auto insurance is obvious. It is important to have adequate liability insurance on an automobile policy in the event of a serious injury to a third party. Homeowner's insurance is important not only to replace the home and its contents, in the event of a fire, for example, but also to protect against liability from injury to a third party on the property. Life insurance is critical to help protect assets in the hands of surviving family members. Life insurance proceeds are generally free from claims of the decedent's creditors.

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♦ **Malpractice Insurance.** Every professional should have adequate malpractice insurance. The amount of the insurance will depend on the professional's exposure to risk.

♦ **Fire, Casualty and Liability Insurance.** Fire and casualty insurance, together with liability insurance, is important if you own commercial real estate.

♦ **Officers and Directors Liability Insurance.** It is essential to obtain officers and directors liability insurance for business owners or individuals serving on a board of directors of for-profit or non-profit entities because for-profit and non-profit boards occasionally make decisions that cause harm to others. Not only are the entities subject to suit, but the officers and directors who made those decisions are also often targets of litigation. By obtaining the appropriate insurance, the officers and directors can better protect themselves financially.

♦ **Personal Umbrella Insurance.** A personal umbrella insurance policy supplements the liability limits on standard policies. The insurance company issuing the policy will have certain minimums for the underlying policies and will cover liability in excess of those limits. Very few people have personal umbrella policies and those who do usually obtain a standard default policy of $1,000,000. Personal umbrella policies are extremely inexpensive. An individual should analyze potential losses and then determine the level of insurance needed. In addition to determining the potential future losses, the individual should take into account personal net worth.

♦ **Business Interruption Insurance.** Unfortunately, when casualties force the closing of a business for a period of time, the expenses of the business typically do not stop. Mortgages and other loans must still be repaid. Often, the business wants to pay its employees in order to retain them. Business interruption insurance is available to provide operating funds even while the business is not operating.

TITLING OF ASSETS

Proper titling of assets can be a useful strategy in asset protection planning, as well.

♦ **Titling Assets in Name of Spouse.** Litigation-prone professionals or business persons may choose to title the bulk of their family assets in the name of their spouse. This may offer some creditor protection, but it could hinder estate planning. Because of higher federal estate tax exemptions and portability of those exemptions, titling assets for estate tax planning is less of a consideration for some individuals than it was previously. Another drawback is that titling assets in the name of one's spouse can cause complications if there is a divorce.

♦ **Tenants by the Entireties.** In the case of married couples, assets can be titled as "tenants by the entireties." This ensures that while a creditor may obtain a judgment that would affect an asset's title, the judgment cannot be enforced so long as both spouses are, in the case of a home, living and residing there. If the non-debtor spouse dies, however, the asset then automatically goes to the debtor spouse and the judgment can be enforced at that time. The other potential problem with tenancy by the entireties is that frequently loans made to professional or business persons require the signature of the spouse. In case of a default on those loans, a judgment could be obtained against both spouses and the judgment could be enforced against tenancy by the entirety property. There are some exceptions to the tenancy by the entirety rule, however. For example, a spouse's interest in tenancy by the entirety property is subject to federal tax lien under I.R.C. § 6321.[1]

♦ **Transfer to Children.** Assets can also be titled in the names of children. However, this strategy has several pitfalls. First, problems arise because children, too, are subject to claims of their own creditors; thus, the transferred assets are still at risk. Second, if the child

[1] U.S. v. Craft, 535 U.S. 274 (2002).

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later becomes divorced, the assets may be subject to claims by the child's ex-spouse. Third, the transferred assets may disqualify the grandchildren from receiving financial aid for college. If assets are transferred to children, the transfers must take place in advance of the claim or incident that may result in a claim in order to avoid negative treatment under the the Fraudulent Transfer Act.

♦ **Titling Assets in Name of Trust.** Assets transferred to a revocable trust are not provided protection from creditors because the grantor of the trust reserves the right to revoke the trust and reacquire the assets. Assets transferred to a self-settled irrevocable trust are also not provided protection from creditors. However, there is an exception: Irrevocable trusts established in a state having legislation providing for Domestic Asset Protection Trusts ("DAPTs") do provide creditor protection. Virginia enacted legislation permitting self-settled DAPTs on July 1, 2012.[2] DAPTs are discussed in further detail later on in this Special Report.

♦ **Homestead Exemption.** Many states have some form of homestead exemption protecting all or some of the value of the primary residence from creditors. Five states, including Florida, protect the entire value of the home while others protect up to a certain amount, often $500,000. Individuals must be legitimate residents of the state in question and must take steps to legally establish that residence.

In Virginia, there is a homestead exemption not to exceed $5,000 per householder (or if the householder is 65 years or older, not exceeding $10,000) with an additional $500 for each dependent.[3]

RETIREMENT PLANS

Generally, there are two types of retirement accounts: ERISA plans and IRAs.

♦ **ERISA Plans.** ERISA plans include employer-sponsored 401ks and defined benefit and defined contribution plans. These include both pension plans and profit-sharing plans. ERISA plans provide protection against all types of creditors. It should be understood that while creditors cannot assert a claim against funds while they are in the retirement account, they could make a claim on any distributions.

♦ **IRAs.** Creditor protection afforded to IRA accounts depends on state statutes and the type of IRA account. The Supreme Court recently confirmed that the type of the retirement account largely determines whether it is protected from creditors. In *Clark v. Rameker*, it held that while a qualified ERISA retirement plan is protected from creditors, an inherited IRA is not protected under federal bankruptcy law.[4] Under the Federal Bankruptcy Act, if the IRA is a rollover from a qualified ERISA plan, it is protected in bankruptcy. In addition, under federal bankruptcy law, the protection is limited to $1,000,000 (indexed for inflation) if the IRA is not a rollover from an ERISA plan. State statute also controls whether retirement plans are protected from creditors. In Virginia, IRAs are partially exempt because the Commonwealth adopted the same protection for IRAs as provided under federal bankruptcy law.[5]

♦ **Protected Income.** Federal law also protects certain types of income from garnishment by some creditors.[6] For example, Social Security benefits, Supplemental Security Income, Veterans Benefits, Civil Service Retirement, and student loan disbursements are generally protected, but they wouldn't be protected from garnishment to collect for child support owed to the federal government.[7]

FORMATION OF BUSINESS ENTITIES

A number of business entities provide protection of business assets from creditor claims. These include

[2] Va. Code § 64.2-745.1.
[3] Va. Code §34-4.
[4] Clark v. Rameker, 573 U.S. ____ (2014).
[5] Va. Code § 34-34.
[6] 42 U.S.C. § 407.
[7] 42 U.S.C. § 659.

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corporations, limited liability companies ("LLCs") and limited liability partnerships ("LLPs"). When creating these entities, it is often helpful to establish separate entities for separate purposes.

♦ **Corporation.** A corporation, when properly operated, protects business assets from creditor claims of business creditors. While under certain circumstances it is possible to pierce the corporate veil, this is fairly difficult for a creditor to do. When it comes to establishing a corporation, however, keep in mind that in order to borrow money to fund the capital requirements of the corporation and/or operating expenses, shareholders will need to personally guarantee the corporate loan. As a general rule, the establishment of the corporation will limit the liability for corporate acts to only the corporation's assets. Thus, a personal guarantee of a loan will expose the assets of the guarantor(s) to claims of the creditor on those particular loans.

♦ **Limited Liability Company (LLC).** For all intents and purposes, an LLC offers essentially the same creditor protection as a corporation with the same trap for the unwary (i.e., personal guarantees).

♦ **Limited Liability Partnership (LLP).** An LLP offers significant protection for its partners. However, the general partner is exposed to creditor claims. A general partner has unlimited liability for acts of the partnership. A solution to this problem is to form a corporation to serve as general partner.

♦ **Separate Entities.** Because entities provide personal protection from creditor claims for the acts of the entity, and this protection limits the exposure of liability to the assets of the entity, a good strategy is to utilize separate entities to own separate business assets. For example, a corporation might be incorporated to operate the daily activities of the business, while a separate LLC might own business equipment and another LLC might own business real estate. Therefore, each entity would be subject to only the creditor claims associated with its respective activities and ownership. A claim against one entity may not jeopardize the assets owned by the other separate entities. When operating separate entities, it is critical to ensure that funds remain separate and not be commingled between or amongst any other personal or separate entity. Funds generated by the operating company must remain in the operating company. Funds generated by the leasing company must remain separate in the leasing company. If the operating company runs low on money, it should not borrow from the leasing company.

DOMESTIC ASSET PROTECTION TRUSTS

Fifteen states have adopted legislation authorizing Domestic Asset Protection Trusts ("DAPTs"). These states include: Alaska, Delaware, Hawaii, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming. Statutes in each of these states vary. This discussion will focus on the DAPT requirements in the Commonwealth of Virginia. In Virginia, DAPTs are also known as, and defined under the Code as, self-settled spendthrift trusts.

♦ **Trust Requirements.** The trust must be:[8]

- ***Irrevocable.*** The trust must be irrevocable.
- ***Inter vivos***. The trust must be created during the settlor's lifetime.
- ***Beneficiary.*** There must be at all times at least one beneficiary other than the settlor to whom income or principal may be distributed (if the settlor's interest relates to income or principal respectively).
- ***Qualified Trustee.*** The trust must appoint at least one "Qualified Trustee" as defined by the Code, who may, but need not, be an independent trustee.[9]

The Qualified Trustee must:

[8] Va. Code § 64.2-745.2.
[9] *Id*.

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- *Keep Custody.* Some or all of the trust's assets must be held by the Qualified Trustee in Virginia;

- *Keep Records.* The Qualified Trustee must maintain records for the trust in Virginia;

- *Prepare Fiduciary Income Tax Returns or Trust Administration.* The Qualified Trustee must prepare or arrange for the preparation of fiduciary income tax returns; *or*

- ***Otherwise participate materially in the administration of the trust.***

- *Situs.* The situs of the trust must be the Commonwealth of Virginia for purposes of determining the trust's validity, construction and administration

- *Spendthrift Provision.* The trust must contain a spendthrift provision as defined in Va. Code § 64.2-743.

- *Distributions*. The settlor cannot have the right to disapprove (or veto) distributions from the trust. This differs from other states that have adopted DAPT legislation.

♦ **Settlor Retained Powers.** The settlor of a Virginia self-settled spendthrift trust may retain the following:[10]

- Special power of appointment (testamentary or other written instrument effective upon the settlor's death);
- Right to receive income or principal of trust subject to ascertainable standard; See also Va. Code § 64.2-745.2 for other rights that may be retained as to income or principal.
- Power to remove and appoint a new trustee; and
- Potential or actual use of real property under a personal residence trust within the meaning of I.R.C. § 2702(c).

♦ **Exceptions to the Spendthrift Protection.** There are certain "super creditors" established under federal law, which trumps state law. Super creditors include, but are not limited to:

- The Internal Revenue Service (IRS)
- The Securities and Exchange Commission (SEC)
- The Federal Trade Commission (FTC)
- Children seeking child support[11]

♦ **Special Needs Trusts.** Special Needs Trusts can be either a Third Party Special Needs Trust (created by and funded with the assets of a family member or other person for the benefit of the person with a disability) or a Self Settled Special Needs Trust ("SSSNT", created with the assets of the person with the disability). The Third Party Special Needs Trust can be protected from the creditors of the beneficiary using a spendthrift trust provision. In some states, if creditor protection is a concern, the SSSNT can be wrapped into a DAPT. A South Dakota court held that a trust created with funds received as a personal injury award was self-settled and, therefore, ineffective against the beneficiary's creditors.[12] However, because federal law requires that a SSSNT be solely for the benefit of the disabled person, [13] a SSSNT cannot be wrapped into a Virginia DAPT. As noted above, Virginia requires that a DAPT have a beneficiary in addition to the settlor.[14] Alternatively, a Virginia resident could wrap a SSSNT into a DAPT created under the laws of another state because Virginia trust code permits a choice of law.

[10] Va. Code § 64.2-745.2(D).

[11] Va. Code § 64.2-744.

[12] Farmers State Bank v. Janish, 410 N.W.2d 188 (1987).

[13] 42 U.S.C. § 1396p(d)(4)(A).

[14] Va. Code §64.2-745.2.

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♦ **Structured Settlements.** While generally a structured settlement is immune from claims of creditors, a court found that a structured settlement was not excludable from bankruptcy under §541(c)(2) of the Bankruptcy Code. The court found that the fund was a self-settled trust and that it was not effective under Washington law.[15] Similarly, a federal bankruptcy court in Illinois held that an annuity received in connection with a personal injury award was not excludable from the debtor's bankruptcy estate.[16]

♦ **Income Tax.** In some states, if a DAPT is established as an irrevocable non-grantor trust without an in-state beneficiary, the income accumulated and capital gains incurred for the non-resident will not be subject to the state's income tax.[17] However, in Virginia, the trust's income and capital gains incurred will be subject to Virginia income tax.[18]

♦**Situs.** A Virginia resident who desires to avoid the income tax consequences discussed above would need to create an irrevocable trust under the laws of another state – for example, Delaware. With respect to situs, the Delaware Supreme Court declared in 1947 that, "In determining the situs of a trust for the purpose of deciding what law is applicable to determine its validity, the most important facts to be considered are the intention of the creator of the trust, the domicile of the trustee, and the place in which the trust is administered."[19] For a Non-Delaware resident to seek income or capital gains tax avoidance, the resident must use a type of Delaware DAPT known as a Delaware Incomplete Non-Grantor Trust (DING Trust).

OFF-SHORE TRUSTS

While arguments can be made that off-shore trusts provide advantages unavailable under a DAPT, there are also risks attendant in an off-shore trust. When establishing an off-shore trust, assets must be moved to that jurisdiction, such as the Cook Islands or the Cayman Islands, to insulate them from creditors. This is expensive and involves many logistical hurdles. Law of the foreign jurisdiction controls, which gives the advantage that the Full Faith and Credit Clause of the United States Constitution does not apply. Laws of those jurisdictions are designed specifically to require a creditor to file suit in the foreign jurisdiction subject to that jurisdiction's laws. The laws in these foreign jurisdictions make it very difficult for a creditor to obtain a judgment. Additionally, trustee powers are very broad, which make it difficult for a creditor to collect from trust assets. However, problems arise because trustees are often non-compliant and there are instances where grantors of these trusts become incarcerated for failure of the foreign trustee to comply with orders of U.S. courts.

DIVORCE & MARITAL CLAIMS

Divorce often subjects an individual's assets to claims of the divorcing spouse.

♦ **Elective Share.** If the decedent transferred assets to the DAPT during marriage without the consent of his or her spouse, it appears that the spouse of a Virginia decedent is able to reach assets in a Virginia DAPT by asserting rights to an elective share. While Virginia law does not explicitly provide an exception to the DAPT for a spousal elective share claim, see Va. Code. § 64.2-305 regarding the assets included in an augmented estate. Delaware law does not defer to the decedent's domicile to determine the surviving spouse's elective share rights, so it is likely that the Delaware DAPT would offer protection against elective share rights even if the grantor of the trust was a resident of another state.

♦ **Prenuptial or Marital Agreement.** A better protection against a claim for an elective share is a valid prenuptial or marital agreement.

[15] *In re* Jordan, 914 F.2d 197 (1990).
[16] *In re* Griffin, 2009 WL 4349001 (Bankr. S.D. Ill. 2009).
[17] For example, Del. Code Ann. Tit. 30, §1636.
[18] *See* Va. Code § 58.1-302.
[19] Lewis v. Hanson, 36 Del. Ch. 235, 128A.2d 819, aff'd 357 U.S. 235 (1958).

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♦ **Separate Spousal Assets.** If an individual enters a marriage with significant assets, never commingles them with marital assets, and never uses the income or those assets to fund the marital lifestyle, courts may find that these assets should be excluded from consideration as martial assets.

♦ **Inherited Assets.** Inherited assets, including stock portfolios, vacation homes, etc., may also be protected so long as they are not commingled with other marital assets. A preferable solution is for the parent or grandparent to leave the inheritance in the form of a discretionary, spendthrift trust, which is protected from both marital and creditor claims. Under Virginia law, the beneficiary may be the trustee of the trust provided the trustee's discretion is limited by an ascertainable standard such as support, health, maintenance and education.[20]

♦ **Discretionary Irrevocable Trust.** If assets that have never been marital assets are placed into an irrevocable discretionary trust with a third party trustee, this would reduce the chances that assets will be considered to have supported the marital lifestyle and, thus, classified as marital property.

TIMING

Timing is the key to implementation of an effective asset protection planning strategy. Virginia has not adopted the Uniform Fraudulent Transfer Act.[21] However, in Virginia, any transfer made with intent to delay, hinder, or defraud creditors, purchasers, or other persons from what they are (or may be) lawfully entitled to, shall be void.[22] Any transfer to a bona fide purchaser for consideration is not affected unless the grantee has notice of the fraudulent intent of the immediate grantor.[23]

There are statutes of limitation for bringing fraudulent transfer claims. Generally, in Virginia, a cause of action for a fraudulent transfer to a DAPT is extinguished unless an action is brought within five years after the transfer was made[24] or, if not recorded, within five years from the time the same was, or could reasonably have been discovered, by the claimant.[25] Virginia is conservative in this aspect because the statute of limitations in many states is four years. Under federal bankruptcy law, a cause of action for a fraudulent transfer to a DAPT is extinguished unless brought within ten years after the transfer was made.[26] Implementation of asset protection strategies should always consider this rule. In transferring assets to a DAPT, an individual is required to execute an Affidavit of Solvency to the effect that the individual has sufficient assets remaining after transfer to the trust to take care of all foreseen expenses.

ARE YOU A GOOD CANDIDATE FOR ASSET PROTECTION STRATEGIES?

There are a number of factors to be considered in answering this question:

- ***Risk Analysis.*** What is the risk that a claim will be brought against you? Most likely, the claim will be in connection with some activity related to your profession or business, but it could be from other causes.

- ***Net Worth.*** What is the size of your net worth?

- ***Implementation.*** Have you implemented all or some of the asset protection strategies listed above?

- ***Willingness to Plan.*** Are you willing to engage in some of the asset protection strategies listed above?

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20 Va. Code § 64.2-746.
21 See Isaac McBeth & Landon C. Davis, III, Bulls, Bears, and Pigs: Revisiting the Legal Minefield of Virginia Fraudulent Transfer Law, U. Rich. L. Rev., 273, 298 (2011).
22 Va. Code §55-81.
23 Va. Code § 55-80.
24 Va. Code § 64.2-745.1(D).
25 See Va. Code §§ 55-81 & 8.01-253.
26 11 U.S.C. § 548(e)(A).

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- ***Investment Assets.*** Do you have significant investment assets outside of your profession or business?

- ***Control.*** Are you willing to give up control of a portion of your investment assets by placing them in a DAPT? It should be noted that not all of your investment assets should be placed in a DAPT. The assets placed in the trust should be assets that you are not likely to need for living expenses. While these assets are available in the event of an emergency, good practice dictates that they be invested to grow and that the income be accumulated in the trust. They are available in an emergency, but should not be used for daily living expenses.

- ***Trustee's Discretion.*** You cannot obtain income and assets from a DAPT simply upon request. Distributions from the trust are discretionary and the trust requires that the trustee follow certain procedures.

- ***Fraudulent Transfer Act.*** Are you considering implementing these asset protection strategies before a claim has arisen and before an incident that may give rise to a claim has occurred?

About This Handout

This guide is provided as a courtesy to help you recognize potential asset protection strategies. It does not (and is not intended to) substitute for legal advice. It is distributed with the understanding that if you need legal advice, you will seek the services of a competent elder law attorney. While every precaution has been taken to make this explanation accurate, we assume no responsibility for errors or omissions, or for damages resulting from the use of the information in this explanation.

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