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Planning for Advanced Asset Protection

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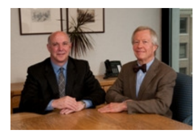

Planning for Peace of Mind.

Asset protection is vitally important in our ever more litigious society, and more wealth planning teams are needed who understand the intricacies of this area and can collaboratively implement advanced strategies. Whether creating an entire plan for the client or creating additional asset protection measures added on to an existing plan, you want to know with a high degree of certainty that the plan will be effective if an attack ever comes.

Asset protection planning is designed to provide increasing levels of protection, starting with where the client is today and moving to where he or she would like to be. Planning appropriately includes making sure there is neither too little nor too much planning.

In this issue of *The Wealth Counselor*, we will review and build on a prior issue ("Asset Protection Planning — Teamwork Is Required for Success"). We will also include some specific advanced asset protection strategies that will strengthen the plans you and your colleagues create for your mutual clients.

The Advisor Team Approach: The Three-Meeting Strategy
Asset protection planning is advanced. It is anything but "one size fits all"! Therefore, it requires both an in-depth understanding of the client and a collaboration of all the professionals involved. Therefore, we highly recommend that an asset protection engagement proceed deliberately and with a structure agreed to in advance by the client and the team members. The recommended and proven structure is:

1. Initial Meeting with Advisors and Client: The purpose of this meeting is to gather financial and objective information and to build a relationship with the client. To preserve the attorney/client privilege, it may be necessary to excuse non-attorney advisors from part of the meeting so the client and attorney can talk freely. It is also important to set some reasonable expectations and explain what asset protection is, how the laws work, and what the client can expect.

2. Advisors' Meeting: After the initial meeting, the client's involved advisors (attorney, CPA, financial advisors, insurance advisors, etc.) meet without the client present to review the client's objectives, discuss various legal and financial solutions, and determine a consensus solution. During this meeting, it is important to lean on the expertise of specific advisors to determine a comprehensive solution. All potential ideas and

concerns should be discussed and explored and differences of opinion ironed out here, not in front of the client.

3. Client Solution Meeting: Here the advisor team presents a unified solution plan, including all legal and financial components, to the client and gets the clients' approval to proceed with plan implementation.

Talking Points for the Initial Meeting
It is important to explain to clients that asset protection is not about hiding or concealing assets. Rather, it is using existing laws appropriately to obtain the best possible level of protection for their assets. The goal is to take advantage of planning opportunities in a way that they can be as defensible as possible if and when the time comes that they are needed.

Client objectives typically include:
* High degree of certainty of the outcome. While there may be circumstances that neither client nor advisors can control, the end result should be considerably better than if the client had done no planning at all.
* Maintain control of their assets and their destiny. This is typically especially important to professionals and entrepreneurs.
* Discourage lawsuits from the outset. Rearranging business affairs and asset ownership can make clients less likely to be personally liable. For example, rental properties that are owned individually or in a revocable living trust can be moved to an asset protected arrangement like a limited liability company (LLC).
* Avoid liability "traps" like partnerships and joint ownership. It's one thing to be responsible for your own actions, but quite another to have your assets vulnerable to the actions of another.

Types of risks faced by clients often include:
* Professional liability: As a general rule, you cannot limit your own professional liability. Also, most states do not permit nonprofessionals to own a portion of a professional practice. Professional liability protection therefore begins with adequate malpractice or errors and omissions insurance coverage.
* Professional liability of a partner or employee: In a partnership, each professional is exposed to liability for the malpractice of every other partner and employee. The practice can be legally structured in such a way that each professional is protected from personal liability for the errors of others.
* Non-practice personal liabilities: These could come from business deals that have gone bad or tort claims (auto accidents, etc.). Within the practice, there could be non-professional liabilities from employment practices, employment discrimination, premises liability, and sexual harassment claims. Again, structures can be set up that isolate clients and client assets from these risks.
* Estate planning risks: These can include unnecessary or excessive income and estate taxes; a partner's next spouse who might be a problem with ownership interests; children's spouses and their behavior which can lead to loss of family assets, etc. These can be dealt with in general estate planning.

The best and most effective time to plan is before a claim arises, when there are only unknown potential future creditors. But even with an existing claim, some options (such as making a contribution to an ERISA qualified plan or doing a Roth conversion) may still be available to shield assets.

Planning Tip: Be aware of potentially fraudulent transfers. Also, because clients often submit incomplete information, obtain a solvency certificate and seek permission to independently investigate their financial situation through online/court house records and other advisors.

Levels of Asset Protection

Level 1: Exemptions: Certain assets are automatically protected by state or federal exemptions. State exemptions include personal property, life insurance, annuities, IRAs, homestead, joint tenancy or tenancy by the entirety. Different states protect assets differently and amounts of the exemptions will vary greatly. Federal exemptions include ERISA which covers 401(k), pension and profit sharing plans. The Pension Protection Act protects up to $1 million in IRAs for bankruptcy purposes.

Planning Tip: Sometimes it is possible to convert non-exempt assets into exempt assets. For example, cash can be used to pay down a mortgage to increase home equity. An IRA that is not well protected under state law could be put into an ERISA qualified retirement plan that is absolutely protected from creditors. Outside cash can be used to pay taxes on a Roth conversion, thereby increasing the net protected asset pool.

Level 2: Transmutation agreements (in community property states): Separate property assets of the "safe spouse" generally are not reachable to pay certain creditors of the "at risk spouse." Community property assets can be converted to separate property for the spouse not at risk, but once transmuted, the property may not become community property again in some states.

Planning Tip: Commutation of community property to separate property will have consequences, including the loss of stepped-up basis on the death of the non-owner spouse. Also, in the event of a future divorce, these assets would already be owned by the "safe spouse." It is important to explain these implications and possible consequences to the clients in writing. Be sure to evaluate commutations from a fraudulent transfer perspective before the transfer.

Level 3: Professional entity formation (PA/PC/PLLC): State laws will vary, but if available, a PLLC is usually more desirable than other forms of entity because of the charging order limitations that prevent a creditor from seizing the creditor's ownership interest in a multi-member entity. Instead, the creditor is often limited to the distributions that would have been made to the affected member. Income tax consequences for the creditor and debtor must also be considered. Using a jurisdiction that makes the charging order the sole creditor remedy is highly desirable.

Planning Tip: Using separate entities or a PLLC can limit liability for a partner's malpractice claims.

Level 4: Equipment and Premises Leasing LLCs: LLCs can be created to own specialized or valuable equipment and/or real estate to remove these assets from the business or professional practice. Lease agreements can then be created between the professional practice and the asset holding LLCs. It is important to segregate real estate, equipment and securities accounts from malpractice exposure and it may be desirable to separate them from each other. The state in which the LLC is formed is very important, as a jurisdiction that allows the charging order as the sole remedy is highly desirable.

Planning Tip: Accounts receivable, which can be significant, can be protected by pledging them to a friendly creditor or factoring them. In the event an unfriendly judgment creditor appears in the future, the unfriendly creditor will not be able to attach to the receivables because they are already pledged or factored to another creditor.

Planning Tip: One structure to consider is creating an irrevocable life insurance trust (ILIT) and funding it with a life insurance policy that is designed to have significant cash build up over time. Using a conventional trust structure that works in every jurisdiction, the insured is not a beneficiary, but the spouse and descendants can be. (If the insured is to be a beneficiary, a self-settled asset protection trust would need to be used.) The ILIT trustee (an independent party) can use discretion and enter into a credit line arrangement with the insured (the business owner/professional). In exchange for granting the credit line access to the cash value of the insurance policy, the insured would need to pledge significant assets to secure the potential drawdown. These pledged assets can include accounts receivable. There are turnkey accounts receivable protection plans that include bundling (creation and funding of the ILIT with a particular insurance product, along with the proper documentation) or the advisor team can create one. Either way, be sure to document carefully.

Level 5: FLP/FLLC to own non-practice assets: Consider forming a family limited partnership (FLP) or family limited liability company (FLLC) to own non-practice assets. These can include personal use real estate, investment accounts, cash or bank accounts, investment real estate and highly valued collectibles (vehicles, artwork, etc.). These can be leased back to an individual for personal use. Again, a favorable jurisdiction that has the charging order as the sole remedy is preferred.

Planning Tip: Ownership interests can be gifted, often at discounted values, and the current $5.12 million gift tax exemption provides an exceptional opportunity to transfer assets this year. Should this exemption decrease to $1 million in 2013, as the law currently states, the ability to make lifetime gifts will be significantly affected.

Planning Tip: With a personal residence, one option would be to borrow the maximum on the mortgage (through a home equity line of credit) and transfer the loan proceeds to an asset protection trust (APT) which then becomes a member of the FLP/FLLC. (Establish the APT first for interim protection.) A second option would be to sell the residence to an intentionally defective grantor trust (IDGT) in exchange for a note that is structured in such a way that it would be unattractive to a creditor.

Planning Tip: A qualified personal residence trust (QPRT) can also be used. Under a QPRT, the grantor retains the right to live in the home for a pre-determined number of years. At the end of the term, the home is owned by the trust beneficiaries, which can include the descendants of the grantor. Because it is a self-settled irrevocable trust, some states have limitations that can reduce its effectiveness for asset protection during the primary term. Also, the funding of a QPRT when there is a known claim could be considered a fraudulent transfer. However, there may be other reasons to use a QPRT, including the ability to do significant gift planning and asset value freezing.

Level 6: Domestic asset protection trusts: Non-practice or leasing LLC assets transferred to a DAPT before any claim arises may provide additional charging order protection. The downsides include having to fund the trust in the jurisdiction that allows it (e.g., Nevada, Delaware, Wyoming, Alaska, etc.) and the need to have a resident trustee in that jurisdiction, which may be a significant ongoing cost. There is also the risk under the Bankruptcy Act of a 10-year clawback for transfers to a DAPT.

Planning Tip: The creator of a non-APT trust cannot be a beneficiary and still achieve asset protection. However, the spouse and children can be the beneficiaries. A flight provision can be included so the assets could go to another jurisdiction if the trust is attacked. A trust protector can oversee the trustee, change the trustee, direct the trustee to move the trust to another jurisdiction, and even be able to decant and move the assets to another trust for the benefit of the same beneficiaries. The alternative is to establish a DAPT in a jurisdiction that allows them, so that the grantor can be a discretionary beneficiary and still achieve asset protection. (Alaska, Delaware, Nevada and Wyoming are often the most popular.)

Level 7: Offshore asset protection trusts: These are established under the laws of a foreign jurisdiction. With an offshore trust, the assets are in the hands of a foreign trustee and are outside the reach of any U.S. court. However, there may be tax issues. Also, if the court orders the assets repatriated and they can't be, the client could be cited for civil contempt and even jailed. In addition, offshore trusts are expensive to establish and maintain.

The Risks of Doing Asset Protection

Proceed with caution when doing asset protection planning for your clients. Be aware of potentially fraudulent transfers, concerns of solvency, and that there may be creditors you don't find out about. It will be much better for you if the client will let you do some level of due diligence. Make sure your client understands the issues and has some reasonable expectations of what the asset protection planning may or may not accomplish. Sometimes the advisors will conclude that it may not be possible to do everything the client wants to do.

Conclusion

Asset protection planning is a challenging and rewarding area in which the advisor team has many opportunities to work together for the mutual benefit of their clients and themselves.