Kilpatrick

Asset Protection Planning from A-Z: 26 Things to Think About Before Jumping In

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Let's work off of this premise: an estate planner's job is to help a client pass their value and values to the following generations to the fullest extent possible, addressing as many of the obstacles in doing so as practical.

The Internal Revenue Code and interpretations thereof are certainly obstacles, but hardly the only ones. Indeed, to the extent our clients are losing sleep over their ability to pass wealth on to future generations, their tossing and turning in the night is typically caused by concerns far beyond taxes. The impact of who knows-how-many other external and societal factors – getting in and out of marriage, increased malpractice concerns, fiduciary and shareholder litigation, stock market swings, economic collapse and political upheaval – cause the greatest client nightmares.

Asset protection planning is (or should be) standard fare for any estate planner. But the truth is that estate planners have always been asset protection lawyers; they just didn't always think of themselves that way. Just think about this: why set up a trust at all if not to produce some level of asset protection now or at death? And really, rotten kids and bad marriages have existed since at least Biblical times. The risk factors change with time, but the need to do the planning does not.

This outline lays out 26 things to consider while engaging in asset protection planning for a client. The items are alphabetized, but other than the discussion at letter A (if you only remember one thing today, that should be it), the items are in no particular order other than the need to creatively cover the alphabet.

***Note**: The information in this outline is, to the best of the authors' knowledge (which can be imperfect), accurate as of November 2024. The reader of these materials should carefully determine the accuracy of these materials and applicability of these materials to their own client situations.*

Always Avoid Fraud

Effective asset protection planning is ALWAYS based on the premise that at the time the planning is implemented, no known or should-have-known creditors will be left holding the bag. Any plan that includes a fraudulent transfer will not provide creditor protection, may cause the recipient of a transfer to be brought into the legal action, and is more likely to give the creditor access to the transferred assets. Not to mention, it may also call into question the ethical standards of the professional advisor.

- For most transactions, the statute of limitations for fraudulent transfers under the Uniform Fraudulent Transfer Act (UFTA), which has been adopted in Illinois, is four years (subject to application of a discovery rule), though some states are longer, such as New York, which has a six-year statute of limitations. The statute begins to run on the day that a transfer is perfected.

- The planner must be able to differentiate between existing, probable, possible, and remote creditors. Transfers that render the client insolvent with respect to existing or probable creditors are likely to be unwound. Transfers with respect to possible or remote creditors are less likely to result in problems (though no guarantees as all facts and circumstances are considered by the courts).

- The debtor can assist by maintaining current balance sheets that show solvency at the time of transfers and by obtaining contemporaneous appraisals of transferred assets showing adequate consideration or reasonable gift values.

- Asset protection planning is generally most effective if valid business, estate planning, or family purposes are the primary objective, with asset protection merely a resulting benefit.

- The key issues to be reviewed for determining whether a transfer is evasive and, therefore, fraudulent, are:

  - The timing of a transfer vis-à-vis insolvency.
  - Whether the creditor existed, was likely, or was merely possible at the time of the transfer.
  - The relationship of the transferor to the transferee.

- The UFTA and UFCA, and the numerous cases interpreting those acts, have also focused on a number of other "badges of fraud" to determine whether a transfer is fraudulent, including:

  - Actual intent to hinder, delay or defraud
  - Adequacy of consideration
  - Openness of the transfer
  - Retained control over the transferred property

Bankruptcy

One of the ideas behind asset protection planning is to avoid the need to invoke the protections afforded debtors under the U.S. Bankruptcy Code. While an individual can often void or otherwise settle his debts in a more palatable manner in bankruptcy, it should often be the course of last resort for the impact it has on an individual's credit and future business prospects. The biggest impact of the Bankruptcy Code on asset protection planning revolves around statutes of limitation on voiding transfers (fraudulent or otherwise) and limits and definitions of exempt assets. Some of the key points for an asset protection planner to consider under the Bankruptcy Code include:

- The statute of limitations for avoiding most fraudulent transfers is 2 years, but the state law of the debtor can apply if it is longer, which it generally is (e.g., 4 years in Illinois).

- The Bankruptcy Code provides a 10-year look back for transfers to self-settled trusts (e.g., domestic or foreign asset protection trusts) made with actual intent to hinder, delay, or defraud present or future creditors. This means, more than ever, that the best asset protection plan has an estate planning or business purpose that can stand on its own aside from the asset protection afforded and that the sooner one plans before a creditor issue arises, the better.

- A debtor can generally choose to apply the exempt asset rules of either the Bankruptcy Code and other federal statutes, or those under state law of the debtor's state of domicile. Domicile is determined by where the debtor resided for the 730 days preceding the filing and if he didn't reside in the same place for that entire period, then by where the debtor resided for the 180 days prior to that period or the longer portion of the 180 day period if not all in one location... If you figured all that out and the debtor still doesn't have domicile in any particular place, then the federal exemption rules apply.

- The Bankruptcy Code limits the exemption on IRAs to $1,512,350, even if state exemption statutes are applied (Illinois, for example, has an unlimited exemption on IRAs). This may make SEPs, SIMPLE-IRAs, 403(b) and other plans more attractive than IRAs, as these accounts are specifically excluded from the $1,512,350 cap.

- Section 529 plans are exempt under the Bankruptcy Code to the extent of amounts necessary to provide for the beneficiary's education expenses (with certain exceptions for contributions made within 2 years of filing).

- A state-level homestead exemption is now limited if (a) the equity in the home is attributable to amounts the debtor "disposed" of with fraudulent intent during the 10 year period preceding the filing, in which case the exemption is reduced by the amount of such disposition, and (b) the debtor bought the home within 40 months of the filing date, in which case the exemption is limited to $189,050, regardless of state law. So, establishing Florida residency and sticking substantial sums into a home trust that may be protected under Florida homestead rule is not likely to protect the house in bankruptcy with respect to a relatively recent Florida residency.

Control

As a general rule, the more control the client retains over the transferred assets, the less protection the client will receive. For example, Illinois does not protect a transferor's assets placed into a trust for the benefit of that transferor. On the other hand, Illinois provides near unlimited protection if the transferor completely divests himself of any retained rights or interest in the transferred assets. Between those two extremes lies a lot of gray. For example:

- It may be OK to have your client remain as nothing more than an investment advisor for a trust that he has funded, but if the trust includes closely held stock and by virtue of other arrangements, such as a shareholder agreement, voting control can be deemed tantamount to control over distributions or other important economic and fiduciary duties with respect to the stock, a court may view that as enough of a retained interest to treat the stock as still belonging to the client (not to mention IRC Section 2036(b) issues).

- Likewise, with a foreign or domestic asset protection trust, it is not advisable to have your client serve as "trust protector," even if that is the client's only contact with the trust. It may lead a court to determine that the protector has enough influence to cause the trustee to make distributions to satisfy a court order, even if the terms of the trust agreement itself do not lend themselves to that result. In a few cases (though none in Illinois and typically none when the client otherwise acted in good faith when setting up the plan) courts have held the transferor with the retained control powers in contempt, relying on the exercise of those powers to cause the release of trust assets to satisfy a creditor.

    - Some cases have held that where a Grantor-Trust Protector maintains only negative powers, such as a veto power over certain decisions by the Trustee, and does not have any affirmative powers over the Trust or Trustee, the Grantor does not have sufficient control over the trust.

    - In *FTC v. Affordable Media*, 179 F.3d 1228, the district court held that because the Grantors-Trust Protectors had affirmative powers over the Trustee, they could repatriate assets held in an offshore trust to satisfy by creditor and held the Grantors in contempt for not doing so. The Appeals Court upheld this decision and the district court's contempt holding. In this case, the Grantors had tried to remove themselves as Trust Protectors, which was also indicative of their knowledge of their control over the trust.

    - Another iffy, but common, circumstance is when the client retains control by serving as manager of an LLC that holds assets contributed by trusts originally funded by the client, though the client has no control or, often, beneficial interest in the trust itself. Again, the extent of the client's control over the underlying assets (and other badges of fraud discussed above) may be determinative of the amount of protection a court affords to the LLC's assets. One strategy for limiting client control of underlying assets is to bifurcate the traditional Manager role. The client can maintain some operational and logistical powers over the entity as "Manager," while all distribution powers and other powers related to the beneficial use or enjoyment over the underlying assets are given to another person designated as a "Distribution Manager" or "Investment Manager."

Due Diligence

When meeting with a client interested in asset protection planning, a key first step is to engage in a thorough due diligence process designed to elicit not only the clients assets and liabilities, but also the potential risks faced by the client (or his assets) going forward, as well as the potential sources of protections available to the client. No discussion of fraudulent conveyance with the client is complete unless the client can associate that discussion with his real world facts and circumstances. Not to mention, going through this process will also protect the advisor when light is brought to bear on the steps recommended to be taken in protecting the client's assets. Among the steps to be taken in a due diligence process with the client are the following:

- Step one is to determine what insurance is available for which risks, including the amount of coverage. Typically you are looking for some combination of malpractice, umbrella, E&O, and D&O coverage, as well as the exclusions to coverage under each policy. You should also inquire as to the level of appropriate business coverage, including not only normal property and casualty coverage, but also workers' compensation, sexual harassment, cyber security, and other specialty policies.

- Obtain a complete personal financial statement, with assets and liabilities. This should be done for the client as well as any of the client's business interests for which liability protection is sought. For example if the client is a CPA, financial statements should be obtained for the client, her practice, as well as any other affiliated entities such as financial planning or valuation services that may be owned or conducted through a separate entity.

- If the client has already been sued, then speak with defense attorneys or hire a lawyer as a consultant who can help you to value the client's worst case scenario should the client lose the suit, along with the risk of the insurer failing to cover the liability (many professional carriers will defend on the basis of a "reservation of right" whereby the insurer will not pay the liability if the ultimate basis of the judgment is shown to fall outside the scope of the coverage). Ask to have the analysis put in writing if at all possible. Knowledge that 99% of professional malpractice cases settle within policy limits is not sufficient due diligence.

- Determine if the client has any professional relationships that could in the near term result in liability. For example, is the client a trustee or other sort of fiduciary for a third party? If so, what is the nature of those relationships from an interpersonal perspective? Is insurance a viable protection option?

- Determine if the client has any investment or business commitments that could result in liability. For example, is the client a general partner on any limited partnerships, has the client provided personal guarantees on any loans, does the client sit on any boards of directors, does the client have capital call obligations, and what is the extent of the client's responsibilities in each of those situations?

- Does the client have any recurring expenditures such as annual gifts, charitable gifts, or retirement plan contributions? It is easier to defend recurring expenditures that continue from the past into the future than those that start around the time that the potential liability arises.

- The planner should inquire into the manner in which any benefit the client is to receive under the client's parents' estate plan is set up. If the parents have not already done so, it makes sense to have any anticipated inheritance placed into trust rather than distributed outright.

We also generally recommend that much of the information obtained in the due diligence process be included in the engagement letter to the client, including a client's solvency statement and acknowledgement that you have had a discussion with the client on the implications of a fraudulent transfers.

Early and Often

No, not voting. Transfers. Time is your best friend and worst enemy in creating an effective asset protection plan. The greater amount of time that elapses between the transfer and the creditor claim, the better. For example, assume that your client is a broker/dealer who is often out selling deals and interests in hedge funds and other invitation-to-a-lawsuit type activities. That client's spouse is a school teacher. The client should be transferring every paycheck to her spouse as received. That way, if a fraudulent transfer claim is made against the client, the creditor will need to go back over every bi-weekly transfer to determine what was known or should have been known about the claim at the time of the transfer. Similarly, the client should make gifts, charitable contributions, IRA contributions, pay summer camp costs and club dues, and other recurring payments on a regular basis. These sorts of patterns are not only more difficult for a creditor to attack in whole, but they also add credibility to a client who states he made transfers without any intent to defraud.

Time between transfer and event is not always a factor. For example, assume that a client perfects certain non-consideration transfers on Monday as part of an overall estate plan. Then on Tuesday, the client causes a terrible car accident and has liability well beyond his policy limits. The transfers made on Monday should not be deemed fraudulent since there was no intent to defraud a known or should have known creditor at the time (of course, this result could change if the driver had a history of drunken driving or an expired license or similar bad fact).

Full Faith and Credit

The biggest drawback of using a Domestic Asset Protection Trust ("DAPT") is that the protection afforded to an out of state grantor is not well-understood. States that do not allow DAPTs generally have strong public policy against protecting assets from creditors. States have refused to enforce choice of law provisions where a resident opts for another state's law, especially if the ties to the designated situs state are weak. The Full Faith and Credit Clause may force a state to enforce the Grantor's home state findings if a creditor brings a claim in the Grantor's home state, not the state governing the trust.

Alaska, Delaware, Rhode Island, Nevada, South Dakota, and Utah all include anticipatory provisions addressing possible conflicts under the Full Faith and Credit clause. The Delaware statute bars all actions unless brought within the appropriate period under Delaware law for such claim, for example, meaning that Delaware will enforce the decision of a non-DAPT state regarding a claim against a non-resident Grantor for trust assets located in Delaware, only to the extent that the claim falls within Delaware's own scheme for enforcement and statute of limitations. Delaware law also provides that if an outside court decides that Delaware law no longer governs the trust, the Trustee of the Delaware DAPT must resign. Limited case law exists challenging these conflicts: In *In re Huber, 2013 WL 2154218,* a Washington bankruptcy court came close to answering this question by holding that a Chapter 7 debtor's choice to have Alaska law govern a self-settled trust (the debtor's home state of Washington does not recognize the validity of self-settled trusts) would not be honored. It is important to note, however, that the court found transfers to the trust to be fraudulent, so it remains to be seen whether another court will rule similarly on the conflict of laws question absent any fraudulent transfers.

GRAT, GRIT, GRUT, CRAT, CRUT, CLAT, CLUT, QPRT, IDIT, ETC.

How we estate planners love our acronyms! As well we should. We used to charge by the number of Latin words and phrases in our documents. Now, we charge by the number of incomprehensible concepts that we present to our clients. But, incomprehensible or not, they can be very effective asset protection tools.

- A client utilizing the Acronym Toolbox is doing so because of the wonderful estate planning benefits associated with those tools. That is, of course, the best defense of any asset protection plan.

- There is little, if any, case law as to whether the annuity interest received back from a GRAT, CRAT or similar vehicle is protected under state law exemption statutes that protect annuities generally, but in any event the underlying principal should be protected since the grantor retained no rights to that property and in fact filed gift tax returns (hopefully and presumably) showing his clear intent to retain no dominion or control over the transferred assets.

    - This may be especially true for a CRAT or other charitable vehicle since courts may be loathe to deprive a charity of the benefit of the planning.

- A sale of assets, whether to a grantor trust (an IDIT, or IDGT, if you prefer) or non-grantor trust, will also protect the underlying asset sold to the trust, even if the payment stream or note is available to the creditor.

- If the client can afford it, the planner should use interest only notes with a balloon payment at the end of the term, as that may be a deterrent to a creditor who wants to be paid up front.

- It is important to obtain a third-party valuation of the asset being sold in order to avoid an unintended gift or fraudulent conveyance. An adjustment clause in a Note is often advisable in the event the IRS adjusts the value of the sold asset upon audit.

- At a minimum, by using these techniques, the client is freezing the value of his estate at the present value of the transferred asset (plus a small interest factor tied to the AFR) so that the future appreciation on those assets should be sheltered from the client's creditors.

Home and Hearth

For many clients, no issue is more emotionally charged than ensuring the protection of the home from the reach of creditors. Protecting the home can be harder than protecting liquid assets for one reason in particular: you can't lift the home up and move it out of its jurisdiction. A sheriff will be able to place a lien against the home almost no matter what planning steps have been taken. But, as with other areas of planning, that doesn't necessarily mean that the client can't place all sorts of obstacles in the way of the sheriff who may want to foreclose on the lien. Four actions are commonly taken that can protect the home from a creditor's immediate reach: give it away, borrow against it to the max, use a tenancy by the entireties, or use a QPRT.

- The best way to protect an asset from a client's creditors is to not own the asset at all when the creditor comes calling. Accordingly, it is common to see a professional such as a lawyer, doctor, architect, or accountant, among others, place title to the family home in the name of their spouse. This works as long as the spouse doesn't also have an out of the ordinary risk profile. Also, the transferring client must balance the benefits of giving the home away against the need to maintain assets in their own name for estate tax exemption purposes or borrowing net worth covenants.

- Illinois provides a $15,000 home equity exemption to each debtor. That isn't much. So a client who cannot utilize their spouse as owner for some reason may consider borrowing against the home to the maximum extent possible, and then placing the loan proceeds in a protected environment, such as an asset protection trust. Certain lenders, including offshore banks, may agree to lend against the home and place the loan proceeds into a CD or other savings vehicle at the bank under which interest earned can be used to cover all or a portion of the debt service.

- For a married couple in Illinois, tenancy by the entireties is by far and away the most common form of home ownership. The beauty of T-by-E is that as long as the couple stays married the creditor of one spouse or the other cannot force a sale of the home to satisfy that one spouse's debt. The danger is that upon death, divorce, or even just a sale of the home, the tenancy is broken and the creditor may then be able to be immediately satisfied. Note that there is an argument to be made under Illinois law, though untested, that a spouse can transfer her interest in the house held by T-by-E to the other spouse without consideration even during the pendency of a claim against that debtor spouse, without fraudulent conveyance concerns. This argument is based on the theory that a lien against only one spouse cannot attach to property held in T-by-E since no divided interest in the property attaches to the debtor. Courts have supported this argument in Ohio, Indiana, and Maryland, which have similar statutes and common law to Illinois on this issue.

    - In *Sawada v. Endo, 57* Haw. 608, both husband and wife transferred property held in T-by-E to their children pending a claim against the husband. The Supreme Court of Hawai'i held that the conveyance could not be fraudulent because the husband had no separate interest in the property but held that a property owned in tenancy by the entirety is not immune from the process of only one creditor if there was 'joint action' by the spouses with respect to the property. Later case law regarding property in Hawai'i since the *Sawada* decision has held that when spouses agree to joint and several liability for a property, *Sawada's* joint action requirement is satisfied, and the property is not protected from the creditors of only one spouse. *DiStefano v. Endurance American Insurance Company,* 620 B.R. 687.

    - In contrast, a joint tenancy is rarely effective as a creditor protection devise. Joint tenancies provide protection for only 50% of an asset's value during the debtor spouse's lifetime.

    - A ruling from the U.S. Supreme Court does allow a federal tax lien to attach to one spouse's interest in tenancy by the entireties property due to the broad language under IRC section 6321. Since a federal tax lien attaches "to all property and rights to property," the Court concluded that the limited rights that one spouse has under state law, such as the right to sell property with the other spouse's consent, were sufficient rights to which an IRS lien could attach. Although the decision authorizes the IRS to administratively seize and sell a taxpayer's interest in real and personal property held in entireties form, the IRS recognizes the limited value of the property right to a potential purchaser (i.e., the right to enjoyment of the property only following divorce, sale of the property, or death of the non-debtor spouse).

- The use of a QPRT as an asset protection device remained untested in the courts until *In re Yerushalmi*, 2012 WL 5839938, in 2012. The bankruptcy court refused to pierce a QPRT that was settled in 1995 and funded in 1996. It held that the QPRT was to be recognized as the owner of certain residential property and that it was not part of the debtor's bankruptcy filed in July of 2007.

    - The Husband (debtor) became embroiled in a partnership dispute in 1998 and divorced the wife in 2002. He was ordered to pay all expenses of the residence, including mortgage payments, taxes, utilities, and insurance. In 2007, debtor filed for Chapter 11 bankruptcy, and the Bankruptcy Trustee sought declaratory judgment that the QPRT was the alter ego of the husband and thus, part of the bankruptcy estate.

    - The court noted that generally under New York law, estate planning trusts are susceptible to attack if used for fraudulent purpose. However, the residence was transferred into the QPRT in 1996 when the debtor had significant assets and disposable income, thereby not finding any fraudulent purpose or improper use.

- Nonetheless, if one combines the idea that the client has retained no interest in the property other than the right to the use of the property (and most creditors are not going to want to share a bedroom with their debtor!) along with the notion that Illinois law protects annuities generally from a creditor's reach, then the QPRT should work or, at a minimum, provide a pretty good negotiating position.

Insurance, IRAs, Annuities, and Other Exempt Assets

Each state's statutes, as well as the Federal Bankruptcy Code, has a laundry list of property that is exempt from the reach of creditors. Typically, these include a portion of equity in a home, some minimal amount of liquid assets, a car, a bible, tools of the trade, and other minimal levels of assets required for basic support needs.

- In a number of states, including Illinois, a debtor may choose to have either the Federal bankruptcy exemption scheme or the state exemption scheme apply. He may not choose both in order to maximize his exempt property.
- Typically, state exemption schemes will protect at least a portion of the value of the homestead.
    - Most states have very limited homestead exemptions. For example, Illinois limits the exemption to a $15,000 interest in the primary personal residence. Texas, Florida and a few other states currently have virtually unlimited homestead exemptions (subject to certain limits in a bankruptcy). Accordingly, a potential debtor residing in one of those states may consider paying off a mortgage on the home.
- Most states, including Illinois, provide that life insurance policies payable to a spouse or dependent, including the policies' cash value, are exempt from creditors. All states have some form of exemption for life insurance. Protection varies and depends on how the policy is written.
    - In most jurisdictions, the proceeds of a life insurance policy will be protected, provided they are not payable to the insured's estate or to a trust that is obligated on the insured's liabilities at death.
    - The exemption varies with respect to cash value, annuities or endowment policies during the insured's or annuitant's lifetime. Some states provide little to no protection. Others offer complete protection, provided the policy benefits the insured's or annuitant's spouse or dependents, even if the insured or annuitant has retained the right to change beneficiaries.
    - Under Federal bankruptcy exemptions, a limited amount of cash value may be exempted from creditor claims.
    - Care must be taken in purchasing life insurance policies to ensure they include any language specifically required by state statute in order to afford protection from creditors.
- Annuities are generally protected from attachment by the annuitant's creditors if payable to a spouse, child, parent, or other dependent of the annuitant.
    - Most statutes do not distinguish between commercial and private annuities, or between annuities that are part of qualified plan payments or non-qualified deferred compensation payments (including Rabbi Trusts).

- Deferred annuities may make sense for a professional planning to retire at a certain date. Payments could be deferred to a date a few years following retirement, thereby possibly getting past statutes of limitations for negligence or malpractice claims.

- For many professionals, retirement plans are among their largest assets. The good news is that retirement plans are generally protected from creditors, even in the case of bankruptcy.
  - In *Patterson v. Shumate*, 504 U.S. 753, the Supreme Court conclusively held that ERISA qualified plan accounts are outside the reach of a bankruptcy trustee or any other third-party creditor by virtue of the statutory anti-alienation provisions under ERISA. As clients get closer to retirement age or otherwise begin to roll their 401(k) accounts into IRAs, the protection afforded by state exemption statutes (and the Bankruptcy Code) becomes that much more important. Importantly, "ERISA-qualified" was not defined by the Supreme Court in *Shumate* and courts have since used various definitions of the same. A common three-part test has been used in the aftermath of *Shumate*, including a plan that must (i) be tax qualified under the IRC; (ii) include an anti-alienation provision; (iii) be subject to ERISA.
  - In *Rousey v. Jacoway,* 544 U.S. 320, the Supreme Court resolved an open question regarding the state law protection of IRA's vis-a-vis bankruptcy law by holding that an IRA account would receive creditor protection in a bankruptcy proceeding, subject to the protection caps under the Bankruptcy Act.
  - Illinois, along with many other states such as California, Texas, and New York, have traditionally provided protection to IRA's in any event, and Rousey was a validation of that position. Still, it is important to note each state provides a different level of protection; for example, in some states, the protection afforded by ERISA may be lost once the IRA rollover is accomplished. Yet other states only provide protection for some types of retirement plans, such as teacher retirement plans and police pensions, or extends protection only to the extent necessary to support the debtor and the debtor's dependents during retirement. For example, Nevada exempts IRA funds up to $500,000, Montana does not exempt contributions from the year prior to the bankruptcy filing, and other states include vague language capping exemption at an amount necessary for support.
  - The conversion of non-exempt assets into exempt assets, such as the contribution of funds to an IRA shortly prior to filing bankruptcy, may be deemed a fraudulent conveyance, and a planner should be careful in advising such a step (and in certain circumstances such a step could even preclude the ability to obtain the protection of the bankruptcy courts). Worse yet, if the bankruptcy trustee is successful in unwinding a last-minute contribution to an IRA, the distribution back out of the IRA could result in an additional 10% penalty for early withdrawal.
  - Whether a plan distribution, once made, is protected from the distributee's creditors depends primarily on state law. ERISA anti-alienation protection terminates immediately upon distribution of the funds to the plan participant. The general rule is that distributions are not protected from attachment once in the hands of a beneficiary except to the extent specifically protected by state law.

- In *Auto Owners Insurance v. Berkshire*, 225 Ill. App.3d 695, the Illinois appellate court found that distributions from a tax-qualified retirement plan would be exempt only if the debtor held the distributed funds in a "cash equivalent account," such as a checking account, and the funds were necessary for the current support of the debtor and his family. In *In re Schnabe*l, 153 B.R. 809, an Illinois bankruptcy case decided about the same time as Auto Owners Insurance, the bankruptcy court provided substantially greater protection for the debtor. In that case, the bankruptcy court looked to the history of the current Illinois exemption statute and determined that the exemption for pension plan payments was no longer limited to the amounts necessary for the debtor's support but would, in fact, apply to any distributions from a qualified plan. This issue remains largely unresolved in Illinois, but the safe course is to assume that *Auto Owners* is applicable.

- The 5th Circuit, on the other hand, looked to federal statutes to provide protection for the debtor. In *In re Ragos,* 700 F.3d 220, the 5th Circuit, relying on Bankruptcy Code section 1325(b)(2) and Social Security Act sections 407(a) and (b), held that social security income should not be included in a Chapter 13 debtor's projected disposable income and may be excluded from the debtor's payment plan. The *Ragos* court held that the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) explicitly excluded social security benefits from the definition of calculating a debtor's "projected disposable income," and the exclusion of this kind of income should be read as intentional exemption of these assets.

- The Supreme Court held in *Clark v. Rameker* in 2015 (134 S.Ct. 2242) that inherited IRAs are not retirement funds for the purposes of bankruptcy exemption. The Court reasoned that the purpose of the exemption for IRAs in bankruptcy is to allow debtors to meet their basic needs in retirement, but that the nature of traditional and Roth IRA guidelines prevent a debtor from experiencing a windfall – the debtor can't withdraw until a set age. In contract, inherited IRAs can be used immediately as a windfall or a 'free pass,' contravening the goals of exemptions in the Bankruptcy Code.

- In many states, a certain amount of wages earned by the Head of Household will not be subject to creditor claims and may be invested in other exempt assets without being considered a fraudulent transfer.

Jurisdiction

Twenty-one states - Alabama, Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming - have all adopted domestic asset protection trust statutes, sometimes referred to as "DAPTs." State laws vary and should be taken into account when choosing the situs of a DAPT.

The selection of the trust situs for a DAPT is not merely ink on paper, but a Grantor who opts for a DAPT under another state's DAPT laws should consider ways to strengthen their contacts with the situs state:

    - Depositing trust assets into an account in the designated state or otherwise using property located in the designated state.

    - Appointing a local trust company, attorney, or other third-party as Trustee, and documenting he Trustee's active involvement in the DAPT, such as through filing tax returns.

    - Give the Trustee sole discretion over distributions to the Grantor.

Asset protection measures like DAPTs should be considered well in advance of possible creditor concerns, but it is not always possible to see into the future. Be prepared and flexible to take alternative or additional actions if creditor concerns arise, or if your client's particular needs (professional liability risk, asset picture, etc.) require. For example:

- Many clients do not wish to give up control and place their assets in an asset protection trust (onshore or offshore) when they do not foresee an immediate risk of a creditor claim. But, it may be wise to include language in a trust or operating agreement that allows a change of jurisdictions at any time. This may be accomplished in any number of ways, including:

    - Allowing the existing trustee or manager, or trust protector, to name a substitute trustee or manager (temporary or permanent, irrevocable or revocable). Note that some states, like Wyoming, will allow the Grantor to change these fiduciaries.

    - Allowing for a change in the jurisdiction of the asset custodian.

    - Providing a trusted party with a limited power of appointment that includes the power to appoint to offshore or other hard-to-pierce entities.

- As storm clouds begin to form, it may be helpful to substitute one asset that may be of greater long-term interest to the client (e.g., a closely held business interest) with another that may be more expendable (e.g., cash). But, it is important that any such substitution be of equivalent value in order to avoid any appearance of fraudulent conveyance. Note that some states, including Alabama, Alaska, and Mississippi, require the Grantor of a DAPT to execute an affidavit of solvency before funding a trust, and substituting trust assets should be carefully considered within the applicable state law.

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- Include language in a trust that allows for disclaimer and specifies what happens to disclaimed trust interests.
    - This may include directing that disclaimed assets be poured over to a particular trust.
    - This may also include a limitation on the disclaimer to a lifetime interest, while retaining a testamentary limited power of appointment.
    - Note that a disclaimer of this nature may not be qualified under IRC Section 2518, which could result in a taxable gift depending on the nature of the disclaimer.

Protection is often not comprehensive. For example, persons entitled to spousal or child support can generally pierce a self-settled trust to the extent of the debt owed. Also, persons who suffer wrongful death, personal injury or property damage at the hands of the grantor on or before the date of the transfer of assets to the trust may also be able to gain access to those assets. The Alaska Trust Act, which became effective in 1997, is illustrative. The statute recognizes the effectiveness of self-settled trusts with four important exceptions: (i) creditors may generally pursue fraudulent transfers into these trusts that are made within four years of the creation of the trust; (ii) the trust will not defeat the claims of a creditor if the grantor may revoke or terminate all or part of the trust against the wishes of a beneficiary or if the trust requires that all or part of the trust's income and/or principal must be distributed to the grantor; and (iii) the transfer of assets to a trust will not be upheld if the grantor is thirty or more days late in making a child support payment.

Kitchen Sink

Does one throw the kitchen sink into the asset protection mix? We generally counsel no.

For a client who is the perfect candidate for significant asset protection planning: the integrity of a plan is going to be called into question if the client is placing personal use assets such as a primary residence, cars, day-to-day bank accounts and the like into the entities created. The plan will be further questioned if the client is pulling funds out of the plan on a regular basis, particularly if there are few limits on the client's ability to do so. A court may view the plan as a sham and take whatever steps it can to disregard the intended protections (much as the IRS views a donor's ongoing use of a family LLC's assets with a jaundiced eye for discount purposes).

Rather, the client should view the plan as a nest egg with a long view. The client should only place an amount of assets into the plan that, all things being equal, the client will not need for a period of years in order to support his lifestyle. Whether the nest egg should constitute 25%, 33%, 50% or more of a client's net worth is largely dependent on the particular facts and circumstances, but it would typically not be advisable to place much more than 50% of the net worth into the plan unless other resources, such as a willing spouse or family trusts, are available to support the client's needs.

The large majority of clients neither require nor desire complex structures. For most, a combination of tenancy by the entireties, retirement plans, transfers between spouses, and property and casualty insurance is appropriate and sufficient. Even in situations in which a more complex structure is appropriate, perhaps involving LLCs and various types of trusts, the client needs to understand how the plan works and his own responsibilities in making it work.

Remember: if a lawsuit arises, the client is going to be deposed and asked to provide documents with respect to the plan. It is essential that the client be comfortable answering any inquiries.

If a client does choose to place substantive assets into an asset protection plan, one way to prepare for ongoing management of risks and rewards of asset protection is to think of the client's overall asset protection plan as a cargo ship. The ship is divided into many holds such that if a leak forms in one hold, the cargo in another will stay dry. It takes a pretty big crack to sink the whole ship. Likewise, one should not place all of their assets into a single vehicle, or hold. If a series of LLCs are utilized, and an uninsured loss occurs with respect to the assets held in one LLC, the assets held in another should not necessarily be at risk. Accordingly, the use of multiple planning vehicles is often recommended and effective.

Limited Liability Entities

Corporations? LPs? LLCs? Given a choice, we almost always prefer an LLC because (a) unlike a corporation, it provides protection to the entity from the owner's creditors, and not just protection to the owner from the entity's creditors (like a corporation), and (b) unlike a limited partnership, a member can actively participate without putting his liability protection at risk. Nonetheless, all are useful and essential tools in asset protection planning, to be counted among the basic building blocks.

- Corporations.
    - If corporate formalities are followed, a shareholder should only have personal liability for corporate level obligations up to the amount of his investment, plus any distributions received during a period of corporate insolvency. Corporate formalities include, at a minimum, maintaining proper books and records, segregating business assets from personal assets, and maintaining appropriate capitalization of the entity.
    - Professional corporations, however, may not shield a shareholder from liability for his own negligence or, in some circumstances, the negligence of another shareholder. Most states have statutes that provide that a shareholder of a professional service corporation or member of a professional LLC shall be personally and fully liable for any negligent or wrongful act/omission if committed by him or any person under his direct supervision and control while rendering professional services on behalf of the entity. In Illinois, the courts have consistently held that the Medical Corporation Act and the Professional Service Corporation Act protect a shareholder from personal liability for acts of another shareholder who was not working under his direct supervision and control. The Illinois Supreme Court has extended this protection to attorneys who are owners of a law firm that is registered as a limited liability entity with the state and that has met minimum insurance requirements defined in Illinois Supreme Court Rule 722.

- Limited Partnerships.
    - Limited partnerships have an advantage over corporations because there is protection in both directions. That is, the limited partner (someone who does not participate in the management of the entity), is protected against partnership level liabilities. Additionally, the limited partner should be protected against a creditor who attempts to seize the limited partnership interest.
    - The primary value of the partnership as an asset protection device is the limitation placed on the ability of a creditor of an individual partner to attach partnership assets to satisfy a debt. For partner obligations, a creditor can generally only obtain a "charging order" against the partner's economic interest in the partnership, but cannot obtain any other rights of a partner, including the right to force a liquidation. Under the Uniform Limited Partnership Act (ULPA) section 22 and the Revised Uniform Limited Partnership Act (RULPA) section 703, a charging order charges the indebted partner's partnership interest with payment of the unsatisfied debt. It does not give the creditor title to the limited partner's interest in the business, but merely gives him the limited partner's right to receive limited partnership income and, upon dissolution, that partner's share of limited partnership assets. Moreover, the charging order holder's right to receive partnership income may place him in the position of receiving phantom income as a result of his lien on the debtor partner's interest, without the ability to force a cash distribution.
    - Several bankruptcy courts have held that a bankruptcy trustee can force a sale of a limited partnership interest. As to the debtor partner, this may have little practical impact since the partnership interest would be attached with a charging order in any event. To the partnership itself and to the other partners, however, a forced sale could have a significant impact.
- Limited Liability Companies. The LLC provides all the creditor protection aspects of both limited partnerships and corporations.
    - One primary attraction of LLCs is that all members can actively participate in management without compromising their limited liability, and there is no general partner who is personally responsible for the entity's debts. If there is a judgment or claim against a member, the creditor is generally limited to the charging order remedy.
    - LLC members may become personally liable if the LLC veil is pierced. The Uniform Limited Liability Company Act (ULLCA) contemplates that the LLC veil may be pierced in a manner similar to the corporate veil.
    - While LLC Acts ought to shield assets held by the LLC from creditors of an individual member, recent judicial decisions have raised the question as to whether a single-member LLC will provide any asset protection when the member is a debtor in bankruptcy court.

- Successful challenges to single-member LLCs have been made in Colorado, Idaho, Maryland, and Florida, in which bankruptcy courts found that the charging order was not the creditors' exclusive remedy and that all of the LLCs' assets were available to satisfy the claims of the single members' creditors.

    - In *In re Albright*, 291 B.R. 538, a Colorado bankruptcy court held that the assets of a single-member LLC could be used to satisfy creditors of the bankrupt member. Albright, the sole member of an LLC, filed a bankruptcy petition. Because the LLC did not go into bankruptcy, Albright argued that the trustee in bankruptcy was only entitled to a charging order remedy. The court disagreed with Albright and held that when the sole member of an LLC goes into bankruptcy, the trustee in bankruptcy may control the LLC in order to sell its assets and distribute the proceeds to the bankruptcy estate. The court noted that the charging order remedy serves to protect the non-debtor members of an LLC from judgments against a debtor member. Therefore, with respect to the single-member LLC, the court determined that the charging order served no purpose because there were no other parties' interests affected.

    - The reasoning set forth in *In re Albright* was later followed by bankruptcy courts in Maryland and Idaho. For instance, in *In re Modanlo*, 412 B.R. 715, the court held that a trustee in bankruptcy appointed for the LLC's sole member had the right to control and manage the LLC ("upon a debtor's bankruptcy filing, the trustee stands in the debtor's shoes and receives the rights and authority that the debtor possessed with respect to the LLC.". Further, in *In re A-Z Electronics, LLC*, 350 B.R. 886, an Idaho bankruptcy court ruled that when the debtor is the sole member of the LLC, the trustee in bankruptcy is entitled to manage and control the LLC to the same extent that the member could. I*n re Penn*, 2010 WL 9445533, citing all three of *Albright, Modanlo,* and *In re A-Z Electronics*, confirmed that the underlying LLC assets do not become part of the bankruptcy; rather, it's the debtor's membership interest that the trustee succeeds to.

    - Finally, in *Olmstead v. Federal Trade Commission*, 44 So.3d 76, the Florida Supreme Court held that the charging order was not the creditors' exclusive remedy against the single-member LLC. The court determined that the charging order remedy serves no purpose when there are no other LLC members to protect. The result of this case was the creation of the "Olmstead Patch" in state law, which states "a charging order is the sole and exclusive remedy by which a judgment creditor of a member or member's transferee may satisfy a judgment from the judgment debtor's interest in a limited liability company or rights to distributions from the limited liability company" for multiple-member LLCs.

    - *In re Mulder*, 307 B.R. 637 - This bankruptcy case out of the eastern division of the Northern District of IL is focused on another issue but the claimant raised analogous defenses to LLC ownership, so the court addressed the logic of *Albright* in the footnotes. Citing *Albright*, the footnotes state that if a debtor owned an interest in the LLC, the interest held by the debtor would be property of the bankruptcy estate, not the property belonging to the LLC itself. Further, the footnotes cites to 805 ILCS 180/30-1(a)(2002): "A member is not a co-owner of, and has no transferable interest in, property of a limited liability company."

Motives

Since a fraudulent transfer by definition requires fraudulent intent, a client's motives are critical. The perfect client is one who says that he has no existing creditors, he has no history of creditors, he has all required licenses for his occupation, he doesn't drink and drive, and he has estate planning, investment, business, or other personal or family goals in mind, but if he could gain some asset protection benefit out of the planning, as well, all the better. And most clients do, in fact, fit within that narrative. But, not all. Your job is to help determine what is motivating the client. Avoid assisting the client who is seeking to escape liability for an existing judgment or potential judgment from an existing lawsuit.

On the other hand, feel good about assisting the client who is clean but losing sleep at the prospect, albeit remote or random, of losing his wealth to a future unknown creditor. That client is simply engaging in the three steps of legitimate asset protection: 1. identifying risk (assets or situations); 2. then, segregating good clean assets from those risks; 3. in order to obtain added leverage in a negotiation with future unknown creditors (while all the while avoiding fraudulent transfers). No court in the U.S. would deny a client that right.

Nuptials

Most states, including Illinois, have laws dating back to the Carpetbagger Era that insulate one spouse from the individual creditors of the other spouse for non-family expenses or obligations. For a married person, this is one of the most important opportunities available in asset protection planning since it allows a potential debtor spouse to place assets into the hands of the less-risk oriented spouse and enjoy protection of those assets from the future creditors of the transferor spouse. Down, dirty, and generally effective.

- And, typically, spouses can transfer title back and forth between themselves with no income or transfer tax consequences.

- In several states, a presumption exists that a simple transfer of title between spouses will not remove the marital property or community property aspect of an asset. To overcome the presumption, there must be clear and convincing evidence that the transfer is meant as an irrevocable gift or an agreement which explicitly transmutes community or marital property into the separate property of an individual spouse. This presumption has the benefit of allowing transfers for creditor protection purposes while still preserving an argument in divorce court that the transferred property did not cease to be a marital asset.

- An inter vivos qualified terminable interest property trust (QTIP) can be effective as long as the donor does not view divorce as a realistic risk, since the transfer will be irrevocable once made. The advantage of using a QTIP is that only the income of the QTIP is at risk, and then only with respect to the donee spouse's creditor.

- Spousal Lifetime Access Trusts (SLAT) are common tools used by estate planners for asset protection for married couples. Generally, each spouse will create their own irrevocable SLAT for the benefit of the other spouse and Grantor and the Grantor's spouse's descendants. SLATs may be funded by any assets, gifted by the Grantor to the trust using the Grantor's gift tax exemption. The assets gifted to the SLAT appreciate outside of the Grantor's estate, free of gift and estate tax. While SLATs are standard practice for many estate planners, it is important to remember the technicalities of these trusts for effective asset protection, including the reciprocal trust doctrine, grantor trust status, gift splitting, valuation timing, communicating risks in the event of divorce. and so on.

- Pre- and post-nuptial agreements can also be effective tools for asset protection by defining which assets belong to which spouse, which liabilities are the responsibility of which spouse, and in the event of asset transfers between spouses, which assets retain their character as marital or non-marital property.

  - Since these are bilateral agreements with bargained-for consideration, they ought to be effective as to the rights of third party creditors, as well.

  - These agreements also implicitly acknowledge what we all know: a spouse is generally speaking a married person's greatest creditor (though most of us – including me, honey, I swear! – have no resentment or problem with that!).

Oversight

One sure fire way for a plan to fail in providing effective protection is for the client to fail to follow corporate and other formalities governed by federal and state law and the terms of the documents. This means that the planner must, at a minimum:

- Provide the client with a written road map of "dos and don'ts" with respect to the entities involved and then regularly chat with the client to ensure he is following instructions.

- Ensure that the CPA is on board and comfortable with the reporting requirements, and that returns are filed in a timely manner. One important step is to determine whether a trust is to be treated as a foreign trust under IRC Section 7701. Offshore trusts and accounts are required to file one or more of a number of returns that many CPAs do not normally come across in their day-to day practices. Just to provide a sample of the IRS's penchant for sadism: Forms 3520 (for transactions with foreign trusts), 3520-A (for foreign trusts with U.S. owner), 8938 (for taxpayers with foreign financial assets with aggregated value over $50,000), 926 (for transfers to foreign corporations), 56 (notice regarding fiduciary relationships), 1040NR (for non-residents), 5471 (for certain U.S. owners of foreign corporations), 8858 (for foreign disregarded entities), 8865 (for foreign partnerships), 8621 (for a shareholder of PFIC or QEF), 1120-F (for a foreign corporation), and 4970 (for accumulation distributions), among others. So, working as a team, especially in the first couple of years, is highly advisable.

- Ensure that investment advisors are placing title to the accounts with the proper entities, that the proper taxpayer ID is being used for each account, and that only the proper parties are given direction over investments or distributions with respect to the accounts.

- Make sure that all trust or LLC distributions are properly documented. For example, if an LLC holds investments and the LLC is owned by an asset protection trust with a third party trustee, and the trust beneficiary is asking for a distribution, the written record should ideally show a written approval of the distribution by the trustee based on the specified circumstances, a request by the trustee to the LLC manager for a distribution, written approval by the manager, and the distribution flowing first from the LLC to the trust, and then out to the beneficiary. And, of course, all of that must be in compliance with the specific terms of the governing documents, which will differ from case to case.

Professional Reputation

Your reputation is worth far more than any professional fee, no matter what. If you don't feel good about a matter, then don't take it on. Easy to say, but hard to implement, particularly if you are dealing with a long-term client. Nonetheless, in the long run you are not doing your client any favors and you are certainly not doing yourself any favors by taking on questionable matters.

Part of the fun, and risk, of asset protection planning is that it requires the lawyer or other planning professional to have multiple skill sets. In addition to the normal arsenal of estate planning tools, such as trusts, an asset protection planner needs to deal with real estate law, business and corporate law, income tax planning and its consequences (on state, federal, and foreign levels), international law, divorce law, environmental law, the differences in different states' laws (nuanced or otherwise), ERISA, debtor/creditor law, myriad reporting requirements, geography (you ought to be able to at least identify Sioux Falls, South Dakota or Luxembourg on a map!), financial statement and tax return analysis, etc. Only a planner comfortable working with a palette of that nature, or at least having access to resources that can assist the planner in those areas, should be advising the client on asset protection strategies.

Qualified Tuition Plans

Clients commonly ask about the protection afforded to their 529 Plans. Illinois legislates that accounts invested in the Illinois College Savings Pool are exempt from the claims of creditors of the participant (i.e., the person who can direct investments, withdrawals, etc.), donor, or designated beneficiary of the account. The protection is limited to the estimated cost of tuition, fees, and room and board for 5 undergraduate years of education, which for 2024 was estimated at $350,000. The protection is further limited to amounts contributed up to the gift tax annual exclusion limits. Section 529 plans are similarly exempt under the Bankruptcy Code to the extent of amounts necessary to provide for the beneficiary's education expenses (with certain exceptions for contributions made within 2 years of filing).

Rush v. Sessions

The seminal Illinois case dealing with asset protection trusts is *Rush University Medical Center v. Sessions* (2012 IL 112906). In this case, Mr. Sessions created the Sessions Family Trust as a foreign asset protection trust in the Cook Islands. He was the grantor and a beneficiary and named himself the Trust Protector. He pledged a $1.5M gift to Rush Hospital in Chicago and based on this pledge, the hospital built a facility. He incorporated this testamentary pledge in his estate planning documents at that time but later revoked them. At death, there was not enough money in his estate to fulfill the gift to Rush. But there were more than enough assets (about $18M) in the Cook Islands Trust to facilitate the gift. Rush sued the Trust for breach of contract and more importantly for our purposes, that the transfer of the assets to the Trust was a fraudulent conveyance and the Trust should be voided. The Illinois trial court sided with the hospital and found that the Trust should be void because Sessions intentionally took actions to avoid fulfilment of the pledge, namely, moving assets to the Trust that he thought would be untouchable by the hospital. The Court of Appeals reversed the decision, and the case went to the Illinois Supreme Court, which sided with the trial court. The question became, then, what could the Illinois hospital recover from a trust based in the Cook Islands? The Cook Islands recognizes self-settled trusts and is not bound by an Illinois Court. But what if the same issue comes up between two states? For example, if an Illinois resident established a Nevada DAPT, would the exemption laws of Illinois (which does not recognize the spendthrift protection of a DAPT) or Nevada apply? Will the Full Faith and Credit Clause bind these decisions?

Separation of Powers

It is critically important for the success of any asset protection trust upon a potential challenge that the Grantor has been kept appropriately separate from the levers of control over the trust. Clients may find it difficult to choose the fiduciaries that will administer and manage the trust and trust assets. Clients should select individuals who they trust, but who will maintain the appropriate separation between the client and the trust. Any number of fiduciaries or quasi-fiduciaries can help in providing protection to a client. These may include trustees, managers, voting trustees, investment trustees, distribution trustees, directed trustees, trust protectors, trustee removers, trustee designators, and investment advisors. Most of these roles are easily and well understood. And in most cases, the idea is to separate as much control as possible from the at-risk client by utilizing these various roles. Including individuals such as trustee removers or designators is often essential to, at least, giving the client an antidote to the separation anxiety caused by placing his assets under another's control.

The one fiduciary that may provide the most asset protection benefit is also the one with the most amorphous title: the trust protector. The beauty of the trust protector is that you can define the role in almost any way that works for the client (subject to public policy or legal restrictions). Commonly, a trust protector can veto distributions or investment strategies, as well as remove and replace a trustee. But, many trusts will also provide the trust protector the right to add, remove, and otherwise change beneficiaries and even, under certain circumstances, trust terms. Whether a trust protector (as well as investment trustees, distribution trustees, etc.) is deemed to act in a fiduciary capacity is not always well defined under state law, so an individual serving in that capacity should seek indemnification language in the trust instrument for acts not taken in bad faith (in Illinois, a trust protector is, by statute, serving in a fiduciary capacity). State law is sometimes unclear as to whether the Grantor can be the trust protector. For example, Alaska defines a trust protector as a third party (meaning the Grantor cannot act in this capacity) but other state codes are silent.

Trusts

Trusts are the Holy Grail of asset protection planning. Planning with trusts dates back to the time of the Crusades when feudal lords would place a trustee in charge of protecting their property while off fighting their infidels. Creative trust design coupled with state or foreign law protections make trusts ideal asset protection vehicles in almost any circumstances.

- It is rare to see a trust instrument that does not include a spendthrift clause. Spendthrift trusts are a cornerstone of estate planning and a key to asset protection. A spendthrift clause generally prohibits a trust beneficiary from alienating his interest in the trust for the benefit of his creditors. Almost all states give effect to spendthrift clauses with respect to most third-party creditors of a trust beneficiary. A spendthrift trust also protects the beneficial interest of a debtor in bankruptcy in the trust, provided that the applicable state law affords protection via a spendthrift clause. Some states have tried to limit the protection of spendthrift trusts, but the courts have interpreted these statutes very broadly to ensure that a beneficiary's interest in a spendthrift trust is protected.

    - Spendthrift clauses are often broad, but it may be advisable to add specific provisions in an appropriate situation. For example, Illinois case law provides that spendthrift language in a "special needs" trust can protect the trust principal from a claim for reimbursement for government assistance (e.g., Medicaid) received by the trust beneficiary.

    - Accordingly, a sentence may be added to the spendthrift clause that specifically addresses government assistance reimbursement in a trust established for the benefit of an individual with special needs.

- The lifetime creditor protection benefits of a revocable trust established for one's own benefit are virtually nonexistent. There is still an advantage, however, to establishing and funding a revocable trust during one's lifetime. Many states, including Illinois, only allow a decedent's creditor to state a claim against probate assets. Accordingly, the assets that fund the trust prior to death may be outside of the creditors' reach, although this position has been little tested by the courts over the years.

    - There is clear authority in Illinois that the assets in a pre-death funded revocable trust will generally not be subject to the surviving spouse's right to take against the will.

- Subject to specific state law, a funded living irrevocable trust established for the benefit of the grantor may provide protection only to the extent of the interest not retained by the grantor. If the grantor has retained a right to the trust income, but not the trust principal, then the principal should remain protected from the grantor's creditors. The issue becomes clouded with respect to spray-type or discretionary trusts, in which case all the facts and circumstances must be explored, including whether the trustee has an interest adverse to the grantor, the extent of the trustee's discretion, and the standard for distribution (e.g., "support" vs. "best interests"). The safest route to protect assets is for the debtor grantor to retain no rights whatsoever in the principal nor any control over beneficial enjoyment.

- The trust terms themselves are also key to the amount of asset protection that can be enjoyed or utilized. For example, trusts can include:
    - Flight clauses (allowing change of jurisdiction)
    - Substitute trustee clauses
    - The ability to create sub-trusts for the benefit (or exclusion) of one or more trust beneficiaries
    - Powers of appointment
    - Restrictions on “duress” distributions
    - Trust protectors who can change trust beneficiaries, terms, or trustees
    - Restrictions on the type of property that can be owned by the trust
    - Restrictions on the sharing of trust information
    - Use of discretionary and broad distributions standards
    - Use of spray trusts
    - Restrictions on covering the expenses of trust beneficiaries or grantors

Use It or Lose It

The estate tax exemption is due to sunset at the end of 2025 to an inflation-adjusted $5M (somewhere around $7.5M). It remains to be seen if Congress will act to prevent the sunset, allow the exemption to grow, or otherwise restructure the federal lifetime estate and gift tax exemption, but if the exemption is decreased on January 1, 2026, a client who has failed to act to reduce their taxable estate by utilizing their remaining exemption will have forever lost the opportunity to do so.

Even we experts cannot foretell whether the sunset will occur, and clients may be unwilling to make substantial gifts or other strategic moves to use their remaining exemption in exchange for the loss of control that comes with such planning before the sunset is a “sure thing.” We can begin having these conversations with our clients now, prepare trusts and appropriate assignments, and obtain valuations, then make the final decision about funding the trusts later in the year when there may be more clarity on the future of the federal exemption amount.

Valuation

One of the best ways to prove that no fraudulent transfer occurred is to be able to show equivalent value received as consideration for any asset transfers. Of course, valuation is often subjective, particularly when dealing with closely held assets or similar assets not readily traded on a public market. Estate planners also have a natural mentality do what is (legitimately) necessary to obtain a lower value for transfer tax purposes. That mentality may not always be consistent with the needs of an asset protection planner who is trying to defend a client's transactions. Accordingly, obtaining independent third party validation on values used in the asset protection planning process is often critical.

Wandry v. Commissioner opened the doors to transferring gifts, subject to change in value, with the use of a formula transfer clause. A *Wandry* clause is a formula transfer clause that creates a fixed value for the assets transferred and adjusts the quantity of the assets to achieve the fixed value. The *Wandry* opinion likened this to "asking for $10 worth of gasoline" rather than a certain number of gallons of gas. This provides flexibility in gift planning whereby a client can gift up to their remaining estate tax exemption, subject to the results of a third-party valuation.

Want, You Can't Always Get What You

Mick Jagger knew of what he spoke. Any planner who promises a guarantee or quick fix in this area is a planner worth avoiding.

- No asset protection plan is completely bulletproof. If a judge is annoyed enough, she may overlook the impossibility defense to contempt or take other extra-judicial steps (e.g., improperly declaring jurisdiction over assets located in another state via jurisdiction over the debtor). The judge may be overturned eventually, but not until plenty of fees have been expended and an incentive to settle provided.

- Sometimes, it is just too late to plan. In that case, though, you may still be able to help out the client for the next creditor, even if you need to leave sufficient assets unprotected to satisfy the current creditor.

- If the assets being protected were ill-gotten in the first place, no amount of planning is likely to help the client preserve those assets. And you need to ask yourself if that is the client you wish to be working with in any event.

- Planning cannot be implemented overnight. In the world of FACTA, CTA/BOIR, international anti-money laundering compacts, banks and trustees, including offshore entities, are very deliberate in their due diligence and the client needs to assume that the process of setting up and funding a plan could take up to a couple of months to complete, even if working diligently.

Xenophobic and Xenophilious

If an asset protection trust is warranted in a given situation, then do I go foreign or domestic with my planning?

The distaste that some U.S. Courts have revealed for asset protection laws of non-U.S. jurisdictions, the sometimes onerous reporting requirements, and most importantly our clients' oft-stated concerns with the perceived negative appearance of offshore planning and the lack of control over one's assets engendered by offshore planning, has led some planners to advocate the use of domestic self-settled asset protection trusts as an alternative to offshore protections.

- Twenty-one states have all adopted domestic asset protection trust statutes, sometimes referred to as "DAPTs." One benefit of using a DAPT is the comfort provided to a client in knowing that the assets remain onshore in a relatively friendly jurisdiction in which the laws are all well understood. Other benefits include:

    - Cost savings. While both offshore and domestic APTs require an up-front investment to establish and ongoing expenses for annual reporting and compliance, DAPTs are less expensive than offshore APTs.

    - Less arduous compliance. Offshore APTs require more regulatory compliance than DAPTs, including additional IRS filing requirements.

- Offshore APTs require a creditor to face numerous difficulties in pursuing an action against the trust, not the least of which is that the action will have to be brought offshore, typically de novo, typically requiring local counsel that cannot charge on a contingency basis, and typically with statutes of limitation that are shorter than most U.S. jurisdictions. Offshore APTs may be more expensive, but they are generally more private and there is substantive legal history behind asset protection planning with typical offshore jurisdictions, like the Cook Islands.

- Additionally, most offshore jurisdictions give little or no recognition to foreign judgments. Many offshore jurisdictions also allow the grantor to remain as a beneficiary of the trust without adverse consequence.

    - To be safe, though, we generally recommend that the client retain as little control and benefit over the offshore trust as possible in order to avoid issues with U.S. courts attempting to cause repatriation of the funds.

    - Choice of jurisdiction is also important. Ensure that the country of choice follows all appropriate international anti-money laundering compacts as well as U.S. Treasury Department and other rules.

- the use of local counsel in establishing the entity is also highly recommended, particularly since not all jurisdictions, particularly those that were never part of the British Commonwealth, have similar rules on trusts or corporate entities. The last thing you want to do is get caught with a Stiftung when all along you meant to use an Anstalt! Local counsel can also help determine the impact of the foreign jurisdiction’s taxes. Determining the existence and extent of any tax treaties with the U.S. is also important.

You Can Run But You Cannot Hide

Secrecy is more of a myth every day. Between IRS reporting requirements, Corporate Transparency Act compliance and Beneficial Owner Information Reports, anti-money laundering laws, the quality of forensic accountants, and lawsuit discovery procedures, the client needs to assume that transparency is the rule and all assets and plans will eventually be discovered. This is often a difficult pill for a client to swallow. But transparency need not and should not be a deterrent: just because something is transparent doesn’t mean that is available to the creditor. In fact, the well-protected client that enters the court room as an open book is likely to get far more support from the court than the client that attempts to hide and hinder.

Zaluda!

Call Jeff! He wants to help!