Current Developments in Domestic and International Asset Protection Planning

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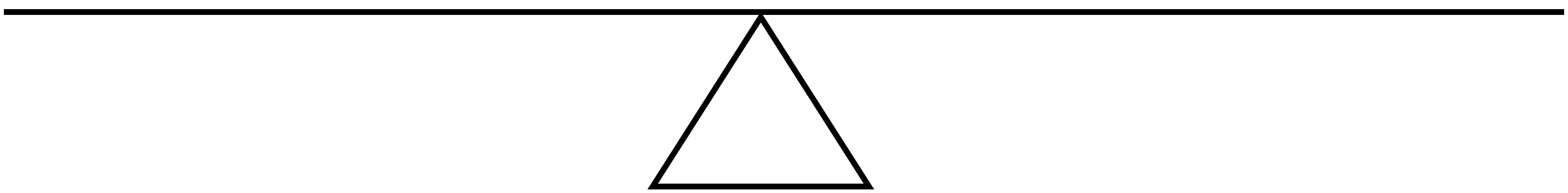
Tension Exists Between Debtors and Creditors

Debtors **Creditors**

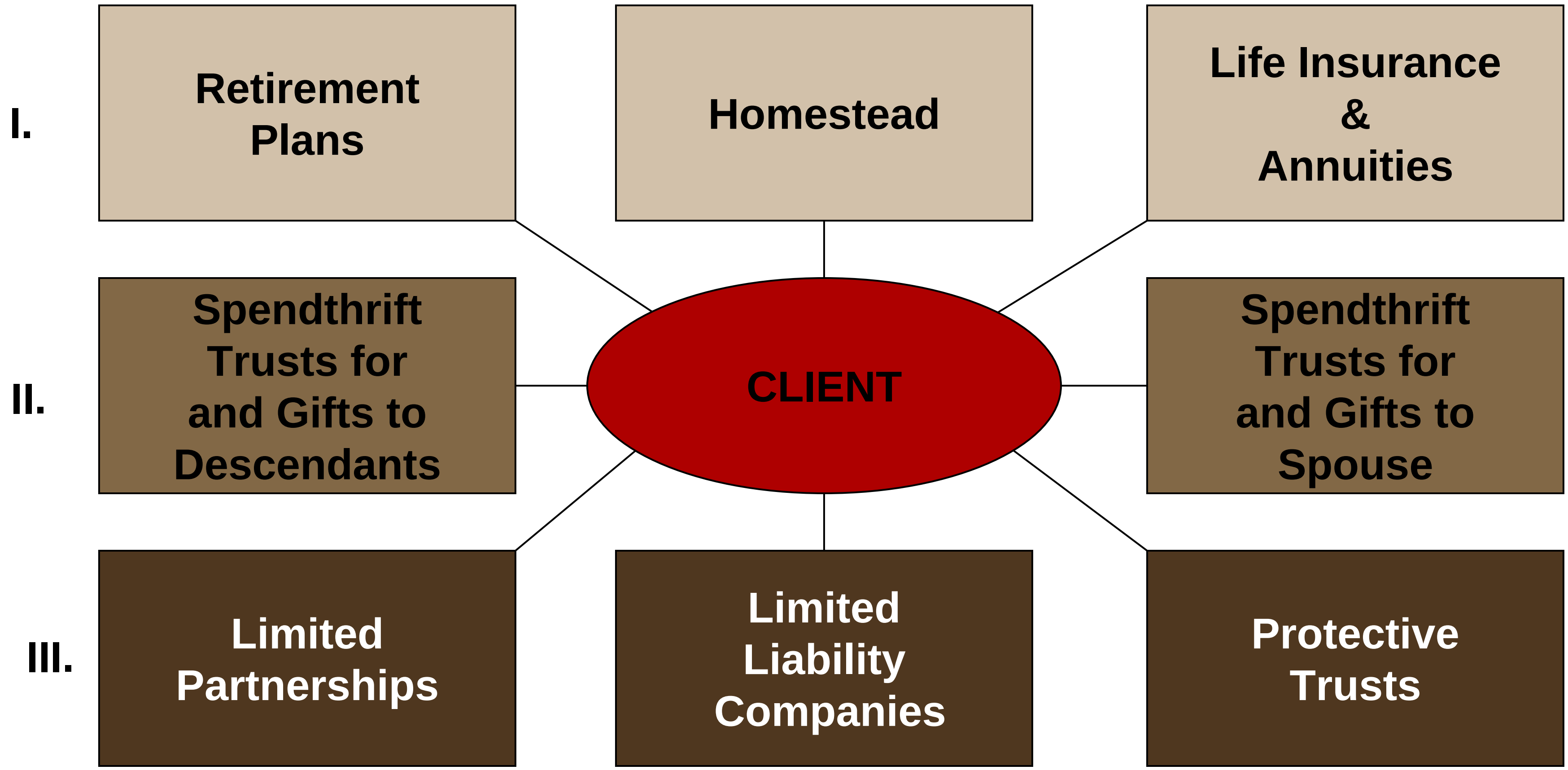


- Fraudulent transfer statutes offer sufficient protection

- Protections other than fraudulent transfer statutes necessary to protect their interests (i.e., spendthrift trust statutes)

(Interestingly, banks agree with the debtors)

Methods to Achieve Asset Protection



Isn't Asset Protection Against Public Policy?

- "[T]he doctrine that the owner of property, in the free exercise of his will in disposing of it, cannot dispose of it, but that the object of his bounty . . . must hold it subject to the debts due his creditors . . . is one which we are not prepared to announce as the doctrine of this court. . . . [E]very State in this Union has passed statutes by which a part of the property of the debtor is exempt from seizure [for] the payment of his debts. . . . To property so exempted the creditor has no right to look . . . as a means of payment when his debt is created [and] this court has steadily held that [such exemptions are] invalid as to debts then in existence [but] as to contracts made thereafter, the exemptions [are] valid. This distinction is well founded in the sound and unanswerable reason, that the creditor is neither defrauded nor injured by the application of the law to his case, as he knows, when he parts with the consideration of his debt, that the property so exempt can never be made liable to its payment."[1]

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

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Creditor Protection: Fraudulent Transfer Law

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

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Solvency Test

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

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Asset Protection and Domestic Business Entities (LLCs and LPs)

- The Issue:

  Can a creditor of an individual partner or member reach the debtor's interest in the entity, the management rights held by the debtor, or the underlying entity assets?

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Asset Protection and Domestic Business Entities (LLCs and LPs)

- Three Creditor Remedies:
  - Charging order
  - Foreclosure
  - Ability of creditor to force a dissolution of the entity

Asset Protection and Domestic Business Entities (LLCs and LPs)

- Charging Order:

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

Asset Protection and Domestic Business Entities (LLCs and LPs)

- **Foreclosure:**

  If a creditor's lien on a debtor's interest in the entity is foreclosed upon, the debtor loses his interest and all of the future benefit in that interest forever (even if that benefit greatly exceeds the debt) including a right to that partner's pro-rata share of the entity's assets at liquidation.

Asset Protection and Domestic Business Entities (LLCs and LPs)

- Ability for Force a Dissolution of the Entity
  - Limited Partnership—Creditors do not have ability to force a dissolution of the partnership
  - Limited Liability Company—Section 503 of the Uniform LLC Act allows a transferee after foreclosure to force a dissolution of the company
    - Dissolution of an LLC has also occurred in the bankruptcy context

Asset Protection and Domestic Business Entities (LLCs and LPs)

More states are becoming “exclusive remedy” states:

Limited Partnerships

- Clear Protection:
  - Alaska
  - Arizona
  - Florida
  - Nevada
  - Oklahoma
  - South Dakota
- Ambiguous Protection:*
  - Delaware
  - Texas
  - Virginia

* “Ambiguous protection” means that the statute contains contradictions (such as referring to a charging order as a “lien”) that call into doubt the strength of the “exclusive remedy” language.

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Asset Protection and Domestic Business Entities (LLCs and LPs)

More states are becoming "exclusive remedy" states:

Limited Liability Companies

- Clear Protection:
  - Alabama
  - Alaska
  - Arizona
  - Idaho
  - Kansas
  - Minnesota
  - Nevada
  - New Jersey
  - North Dakota
  - Oklahoma
  - Tennessee
  - Wyoming
- Ambiguous Protection:*
  - Delaware
  - South Dakota
  - Texas
  - Virginia

* "Ambiguous protection" means that the statute contains contradictions (such as referring to a charging order as a "lien") that call into doubt the strength of the "exclusive remedy" language.

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“Traditional” Spendthrift Trusts

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

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“Asset Protection” Trusts

- Definition
  - The Settlor (the person who transferred assets to the trust) is a beneficiary of the trust; and
  - The assets that the Settlor transferred to the trust are protected from the claims of the Settlor’s creditors

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Asset Protection Trusts – Two Very Different Options

- Domestic
  - Historically was not available in the U.S., but in recent years, more states are passing protective trust legislation

- Foreign
  - Available in many foreign countries

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Domestic Asset Protection Trust States

- Missouri – 1986*
- Delaware – 1997
- Alaska – 1998
- Nevada – 1999
- Rhode Island – 1999
- Utah – 2003
- Oklahoma – 2004*
- South Dakota – 2005
- Tennessee – 2007
- Wyoming – 2007

*Missouri and Oklahoma are not "true" asset protection trust states, but they have passed legislation attempting to make trust assets more protected.

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Common Threads in Domestic Protective Trust Legislation

- **The only claims that are allowed (other than child or spousal support) are fraudulent transfer claims**
  - Alaska, Delaware: Actual intent to defraud the particular creditor who is attacking the trust
  - Nevada: A transfer is valid if it is "not intended to hinder, delay, or defraud known creditors"
  - Rhode Island, South Dakota, Tennessee, Wyoming: provide that the claim must be brought under the UFTA
  - Utah: Actual intent to defraud the particular creditor attacking the trust, but Utah also provides the following broad exceptions, which appear to be in addition to fraudulent transfer claims:
    - Judgments or other legally enforceable decisions resulting from a proceeding commenced prior to, or within 3 years after, the trust was created
    - Transfers made when the settlor is insolvent, or that render the settlor insolvent
    - Judgments, awards, or other determinations of liability for fraud, intentional infliction of harm, or a crime

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Common Threads in Domestic Protective Trust Legislation

- **Burden of proof is on the creditor to prove his claim by clear and convincing evidence**
  - Delaware
  - Rhode Island
  - South Dakota
  - Utah

Common Threads in Domestic Protective Trust Legislation

- **Statutes of limitations on fraudulent transfer claims**
  - Delaware, South Dakota:
    - If the claim arose before the transfer, the limitation periods set forth in the UFTA apply
    - If the claim arose after the transfer, 4 years
  - Alaska, Rhode Island:
    - If the claim arose before the transfer, 4 years, or 1 year after the transfer was or reasonably could have been discovered
    - If the claim arose after the transfer, 4 years
  - Utah, Tennessee, Wyoming:
    - Presumably, the relevant limitation periods set forth in the UFTA
  - Nevada:
    - If the creditor is a creditor when the transfer is made, 2 years, or 6 months after the transfer was or reasonably should have been discovered
    - If the creditor became a creditor after the transfer is made, 2 years

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Common Threads in Domestic Protective Trust Legislation

- **Protection for third parties who assisted in implementing the trust**
  - Alaska
  - Delaware
  - Rhode Island
  - South Dakota
  - Tennessee
  - Wyoming
  - Utah

Common Threads in Domestic Protective Trust Legislation

- **Prior to a transfer, the settlor must sign an affidavit stating that the transfer is not made with fraudulent intent, the transfer will not render the settlor insolvent, the settlor has no pending or threatening court actions against him, and the settlor does not plan to file for bankruptcy.**
  - Alaska
  - Tennessee
  - Wyoming (Wyoming also requires the settlor to maintain personal liability insurance in the amount of the lesser of $1 million or the fair market value of total transfers to protective trusts)

Common Threads in Domestic Protective Trust Legislation

- **If a court declines to apply the law of the trust, the trustee will immediately cease to act and the next named successor will serve (or, if no successor is named, a successor appointed by a court in the state).**
  - Delaware
  - Rhode Island
  - Tennessee
  - Wyoming (Wyoming does not provide for automatic dismissal of the trustee, but allows the trustee to resign)

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“Quasi” Asset Protection Trust States

Missouri:

- A spendthrift provision will prevent the settlor’s creditors from satisfying claims from the trust assets, except to the extent of the settlor’s beneficial interest in the trust assets, if at the time the trust became irrevocable, the settlor:
  - was sole beneficiary of either the income or principal;
  - retained the power to revoke or amend the trust; or
  - was one of a class of beneficiaries and retained a right to receive a specific portion of income or principal that was determinable solely from the trust document.

Oklahoma:

- A “preservation trust” is protected from the settlor’s creditors up to $1 million (plus increases in value and income on that $1 million):
  - The settlor cannot be a beneficiary, but the settlor’s spouse can be

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States Repealing, Extending, or Modifying the Rule Against Perpetuities

- **Alaska** (no RAP if trustee has power to sell trust assets)
- **Arizona** (no RAP if trustee has power to sell trust assets)
- **Colorado** (1,000 years)
- **Delaware** (RAP abolished as to personal property; 110 years for real property)
- **Idaho** (RAP abolished as to personal property; common-law Rule for real property)
- **Illinois** (RAP does not apply if trust expressly states it and trustee has power to sell assets)
- **Maine** (RAP does not apply if trust expressly states it and trustee has power to sell assets)
- **Maryland** (RAP does not apply if trust expressly states it and trustee has power to sell assets)
- **Michigan** (legislation introduced to abolish RAP as to personal property)
- **Missouri** (no RAP if trustee has power to sell trust assets)
- **New Jersey** (abolished)
- North Carolina (no RAP if trustee has power to sell trust assets)
- **Rhode Island** (abolished)
- **South Dakota** (abolished)
- **Tennessee** (360 years)
- **Utah** (1,000 years)
- **Wisconsin** (no RAP if trustee has power to sell trust assets)
- **Wyoming** (1,000 years)

Offshore Protective Trusts Offer Additional Benefits

- Creditors cannot reach assets through U.S. court system
- U.S. judgments are not enforceable
- Cost of pursuing assets offshore is high; loser-pay systems
- Punitive damages and contingent fee contracts not allowed
- Secrecy and privacy laws prevalent and strictly enforced
- Restrictions on discovery “fishing expeditions”

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Developments in International Asset Protection Planning

- Switzerland passes the Hague Convention on the Law Applicable to Trusts and on Their Recognition – effective July 1, 2007
  - Switzerland will apply the governing law of the trust chosen by the settlor
  - Convention provides specifically that:
    - The trustee's personal creditors cannot reach the trust assets
    - The trust assets are not part of the trustee's estate upon the trustee's bankruptcy
    - The trust assets do not become part of the trustee's marital property
    - The trust assets are not part of the trustee's estate upon his death
    - The trust assets may be recovered when the trustee, in breach of trust, has mingled trust assets with his own, or has alienated trust property
    - Trustee may register trust assets in its name "as Trustee"

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Developments in International Asset Protection Planning

- Stephan Jay Lawrence (In Re Lawrence, 279 F.3d. 1294 (11th Cir. 2002))
  - In 1991, Lawrence fraudulently transferred 90% of his assets into an offshore trust on the eve of an arbitration judgment
  - The court acknowledged that pre-bankruptcy exemption planning was acceptable, but Lawrence's fraudulent and evasive behavior was not acceptable pre-bankruptcy planning
  - As a matter of public policy, the court did not allow him to unilaterally remove property from the bankruptcy estate simply on his choice of situs for the trust and therefore applied Florida law to determine his rights in the trust assets
  - The court found that Lawrence had actual control over the trust assets and ordered him to repatriate the assets
  - Lawrence claimed that it was impossible for him to comply with the court's order
  - The court found that this impossibility was "self-created," jailed him for civil contempt, and fined him $10,000 as day until he purged his contempt

Developments in International Asset Protection Planning

- On December 12, 2006, Lawrence was released after being incarcerated for more than six years.
- The judge ruled that Lawrence's continued incarceration no longer served its purpose to coerce him to repatriate the trust's assets, and that there was no possibility that he would comply with the court's order because he valued his money more than his liberty.

Developments in International Asset Protection Planning

Levin-Coleman-Obama Stop Tax Haven Abuse Act (S.681, February 17, 2007)

- Purpose is "to restrict the use of offshore tax havens and abusive tax shelters to inappropriately avoid Federal taxation"
- In fact, there is no such thing as a "tax haven" or "tax shelter" for U.S. taxpayers
  - Foreign trusts and entities created by U.S. persons to hold passive assets are either treated as "pass-throughs," or the income accumulated within the trust or entity will be subject to a punitive interest charge when it is distributed (e.g., foreign trusts, CFCs, PFICs)
  - Informational reporting is currently imposed on U.S. persons who create, fund, or own interests in, foreign trusts and entities; failure to file carries heavy penalties
  - Any U.S. person using an offshore trust or entity to avoid U.S. tax is already breaking laws currently in place

Developments in International Asset Protection Planning

Levin-Coleman-Obama Stop Tax Haven Abuse Act (S.681, February 17, 2007)

- Establishes "offshore secrecy jurisdictions" with secrecy laws or practices that "unreasonably restrict" U.S. tax authorities from obtaining information
  - Anguilla
  - Antigua and Barbuda
  - Aruba
  - Bahamas
  - Barbados
  - Belize
  - Bermuda
  - British Virgin Islands
  - Cayman Islands
  - Cook Islands
  - Costa Rica
  - Cyprus
  - Dominica
  - Gibraltar
  - Grenada
  - Guernsey/Sark/Alderney
  - Hong Kong
  - Isle of Man
  - Jersey
  - Latvia
  - Lichtenstein
  - Luxembourg
  - Malta
  - Nauru
  - Netherlands
  - Antilles
  - Panama
  - Samoa
  - St Kitts and Nevis
  - St. Lucia
  - St. Vincent and the Grenadines
  - Singapore
  - Switzerland
  - Turks and Caicos
  - Vanuatau

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Developments in International Asset Protection Planning

Levin-Coleman-Obama Stop Tax Haven Abuse Act (S.681, February 17, 2007)

- Establishes presumptions in tax and securities proceedings, rebuttable only by clear and convincing evidence – no evidence may be accepted from a non-U.S. person unless the person appears to testify in the proceedings
  - <u>Control</u> – if a U.S. person directly or indirectly formed, transferred assets to, was a beneficiary of, or received distributions from, an Offshore Secrecy Jurisdiction entity or trust, it will be presumed that he exercises control over the entity or trust
    - Ignores basic trust and entity concepts
  - <u>Income</u> – in a tax proceeding, any amount or thing of value transferred <u>to</u> or <u>from</u> a U.S. person directly or indirectly <u>from</u> or <u>to</u> an account, trust, or entity in an Offshore Secrecy Jurisdiction will be presumed to represent previously unreported income in the year of the transfer
    - Ignores pass-through nature of most foreign trusts and entities

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Developments in International Asset Protection Planning

Levin-Coleman-Obama Stop Tax Haven Abuse Act (S.681, February 17, 2007)

- Requires any financial institution directly or indirectly opening a financial account or creating a trust or entity in an Offshore Secrecy Jurisdiction for a U.S. client to report the transaction to the IRS providing:
  - Name, address, and TIN of the U.S. client
  - Name and address of financial institution where account is opened
  - Type of account, account number, name of account, and amount of initial deposit
  - Name and address of trust or entity and the name and address of any professional employed to form the trust or entity

Developments in International Asset Protection Planning

Levin-Coleman-Obama Stop Tax Haven Abuse Act (S.681, February 17, 2007)

- Foreign Trusts:
  - All powers and interests held by a trust protector are attributed to the grantor
  - A U.S. person who receives or uses cash or other property from a foreign trust will be treated as a beneficiary, unless there was a fair market value exchange
  - Loans of real estate, marketable securities, and any personal property treated as taxable trust distributions

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Developments in International Asset Protection Planning

Levin-Coleman-Obama Stop Tax Haven Abuse Act (S.681, February 17, 2007)

- Extends from 3 years to 6 years the amount of time the IRS has after a return is filed to investigate and assess additional tax if the case involves an Offshore Secrecy Jurisdiction
- Increases current penalties for:
  - Promoting abusive tax shelters (IRC §6700): up to 150% of promoter's gross income from the activity (increased from 50%)
  - Knowingly aiding and abetting an understatement of tax (IRC §6701): up to 150% of aider/abettor's gross income from the activity (increased from $1,000)
  - FBAR penalties tied to the highest balance in the account during the year (currently tied to the balance at the time of the violation)

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