

SPECIAL REPORT

“What Do We Mean When We Say... Asset Protection Planning?”
by Francis Burton Doyle, Esq., *WealthPLAN*



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The purpose of this article is to raise the consciousness of estate planning professionals to the importance of integrating asset protection principles into the estate plans of their clients. The starting point to understanding asset protection planning is the California law of fraudulent conveyances and the Federal Bankruptcy Act. There are civil and criminal penalties, which require practitioners to fully “vet” the client before undertaking to assist the client with asset protection planning. Conceptually, asset protection is similar to federal estate tax planning; rather than protecting assets from the IRS, the goal is to protect assets from creditors.

In California, the statutory authority governing fraudulent conveyances is found at California Civil Code section 3439 and the following. Under California law, any transfer made with the actual intent to hinder, delay, or defraud either existing or future creditors are fraudulent. In addition, a transfer made under circumstance trained by two or more “badges of fraud” will constitute a fraudulent conveyance.

If actual intent to hinder, delay or defraud a creditor is established then the solvency of the debtor or his ability to pay creditors is irrelevant. (*Herrernan v. Armour* (1952) 239 P.2d 129.) Accordingly, in transferring assets in the estate-planning context it is important to establish an estate planning purpose of the transfers. This is similar to the “business purpose” doctrine, which we so often encounter in the tax-planning arena.

The following “badges of fraud” will taint transfers. And the existence of any two or more of these “badges” will put the transfer in jeopardy of being deemed fraudulent. The badges of fraud include:

- a. transfer for less than, reasonably equivalent value;
- b. insolvency at the time of the transfer,
- c. transfer to an insider;
- d. debtor remained in possession or use of the transferred property

- e. concealment;
- f. transferor was the subject of litigation;
- g. transfer made just before large obligation is incurred;
- h. debtor absconded; or transfer included substantially all of the transferor's assets.

Rather than rely on a haphazard judicial way of applying the "badges of fraud" test on a case-by-case basis, many state legislatures have adopted a statute, which finds a constructive fraud in any of the following circumstances:

- a. the transfer is made when the debtor is insolvent or the transfer will render the debtor insolvent;
- b. the debtor is engaging in a transaction or is about to engage in a transaction with unreasonably small capital; or
- c. the debtor intends to incur or believes he will incur debts beyond his ability to pay such debts.

California and federal bankruptcy code have adopted this test. It is important to purge the "taint" on the transfer by establishing that the debt or claim is meritless, the statute of limitations has expired, or by taking measures to satisfy any present or future creditors. The Federal Bankruptcy Law preempts California Law, for example, by statute a disclaimer is not a fraudulent conveyance. (Prob. Code, §283) However, under federal bankruptcy law, a disclaimer would be a fraudulent transfer. (In re Clark (1980) 410 A.2d.796) The bankruptcy law has its own myriad of technical time sensitive rules relating to preemptive and other transfers. For example, a transfer to a creditor within 90 days of filing bankruptcy is deemed a preferential transfer and thereby voidable. The basic principles of Interspousal Planning include the following: In general, one's separate property cannot be seized to satisfy the debts of one's spouse. There is an exception for "necessaries of life."

In general, community property cannot be seized to satisfy the separate property liabilities of one's spouse. An important distinction exists between "characterizing" separate and community property and "transmuting" separate property to community or community property to separate property. A transmutation is subject to the fraudulent conveyance rules discussed above whereas a characterization of property is not subject to those rules.

Planning techniques include Marital Property Agreements, which allows the client to keep income and assets separate which would otherwise become community and subject to a spouse's

liabilities. QTIP Trusts also protect one's estate from a surviving spouse's creditors. The Transmutation Agreements to the extent they can withstand the scrutiny of the fraudulent conveyance rules. Important divorce considerations include accelerating the divorce process where the nonasset bearing spouse is experiencing financial difficulty. It is important to delay divorce if the asset bearing spouse is experiencing financial difficulty. There are a variety of Domestic Trusts to use as an asset protection device such as the following:

- Grantor Trusts: In general, grantor trusts do not protect assets from the creditors of the grantor. (Prob. Code, § 15304.) However, a strict reading of the statute leaves open the possibility that certain "grantor" trusts could provide a modicum of protection for trust assets from the grantor's creditors.
- Spendthrift Trusts: Subject to certain proscribed statutory exceptions, the validity of spendthrift clauses is confirmed by statute in California. (Probate Code, §15300 and §15301.) The exceptions exclude spendthrift protection for child support payments, restitution judgments, and reimbursement for public support payments. In contrast, spendthrift clauses are not enforceable under English law
- Discretionary Trusts: Subject to the child support, restitution judgment and public support exceptions discussed above, the general rule in California is that creditors of a beneficiary cannot force a trustee to exercise discretionary authority in their favor.
- Support Trusts: Subject to the child support, restitution judgment, and public support reimbursement exceptions and a special "necessaries of life" exception, creditors of beneficiary cannot attach trust assets to the extent they are needed to provide a beneficiary with the support intended by the grantor. (Prob. Code, §15307.)

The General Power of Appointment Issue: Assets subject to a presently exercisable power of appointment are subject to claims of the power holder's creditors. (Prob. Code, §680, et seq.)

The Probate Code §15306.5 Attachment Issue: A court in its discretion may order a trustee to pay over to a creditor 25 percent of the payments, which a beneficiary would otherwise receive

- Contingent Beneficial Interests: Concept is that unvested beneficial interests are inchoate interests, which are unvested and for that reason not attachable by creditors.

The core concept regarding family partnerships is that by forming a partnership, the creditors become unable to reach partnership property and the creditor's remedy is limited to trust of a changing order. Use of changing orders is cumbersome and can naturally be detrimental to the creditor.

The most typical structure is a Family limited partnership with a corporate general partner. An issue arises as to whether or not the partnership will be taxed as an association taxable as a corporation. (I.R.C. §7100) So long as the partnership agreement precludes full transferability of interests to the limited partnership, it should be taxable as a partnership.

There are several asset protection guidelines to follow with the Family Limited Partnership Agreement, such as:

- Should use a limited partnership rather than a general partnership.
- Include a provision for a successor general partner.
- Use Anti-liquidation and dissolution restriction such as super majority requirements.
- Include restrictions on transfer with specific language that if an impermissible transferee obtains title to partnership units, they will not be considered a partner
- The partnership agreement should allow assessment on all unit holders (whether or not partners).
- Include the triggering of optional buyout provisions of the other partners, with extended payout provisions.
- Have transfer fees and service fees built into partnership agreement to make the creditor pay for becoming a unit holder.
- Use guaranteed payments, which work to devalue the partnership units because they are essentially an encumbrance on the partnership.
- Indemnification of the general partner. May be very valuable where there is even the specter of a toxic problem.

The Charging Order is an exclusive remedy. Code of Civil Procedure §487.020(a) and Code of Civil Procedure §699.720 (a). Creditor may not execute against the underlying partnership property. [This is true even in the case of a general partnership.] (Cal. Corp. Code, §§ 15028, 15222, and 15673.) Anti-dissolution and liquidation rules are extremely important because partnership interests can be foreclosed on. (Hellman v. Anderson (1991) 284 Cal.Rptr. 830.) [Creditor must prove that foreclosure does not unduly interfere with partnership business.] What does the charging order do? Diverting distributions attributable to the interest to the creditor rather than the partner. Hellman v. Anderson (op. cite). General partnership-- no liquidation or dissolution because it would be unduly disruptive to the business of the debtor. Contrast: Crocker National Bank v. Perroton, (op. cite) where limited partnership ordered sold where creditor received nothing as a consequence of the charging order.

Limited Liability Corporation's have numerous tax advantages over both C corporations and S corporations. They prevent the double tax problem of a C corporation and provide more flexibility, in allocating profit and loss among owners than an S corporation.

As opposed to a limited partnership, the LLC allows its members to actively participate in the management of the company without jeopardizing the member's limited liability. Further, the LLC eliminates the need for a general partner with residual liability for the activities of the partnership (usually a corporation which must be maintained at some time and expense). §17302 of the California Corporations Code makes the charging order the exclusive remedy an LLC owner's interest becomes subject to a creditor's judgment. Considerations during Asset Protection planning include:

- A debtor's interest in on LLC does not entitle the creditor to reach underlying assets charging order.
- Valuation and buy-out option terms can be used to limit creditor's rights.
- Operating agreement can provide that a creditor who seizes an interest in an LLC does not automatically become a partner.
- A Charging order appears to be the exclusive remedy--but because of newness, selling and foreclosure may be a possibility.

- Bankruptcy trustee could sell an interest in an LLC despite any state law restrictions. –LLC operating agreement will be treated by bankruptcy trustee as an existing contract under Bankruptcy Code §365 if viewed as a personal service contract, the bankruptcy trustee would be prohibited from assuming liability for personal services, i.e., as a manager or officer of the LLC.

Other liability aspects of LLC Membership are that the LLC structure provides limited liability for members even if they participate in the management of the business operation. Use of an LLC, however, does not prevent individual liability for torts or other liability of LLC member incurred as an individual. LLC members are liable for agreements to contribute capital. LLC members are liable for making distributions to members when the LLC is insolvent. There is a possibility of piercing the "LLC veil."

When drafting the LLC Operating Agreement plan to provide that assignee of an LLC interest does not automatically become an LLC member (include successor manager provisions). Provide that personal services are required of all LLC members (so as to exclude a bankruptcy trustee from assuming rights under an operating agreement). Include buyout option or terms for other LLC member. Anti-liquidation or dissolution provisions which preclude creditor assignee from dissolving or liquidating the LLC Indemnification of other LLC on members

- Additional contribution language.

The general rule in Family Corporation is that shareholders are not liable for the debts or other liabilities of a corporation. In order to obtain the benefits of this rule, the subject corporation must:

- Adhere to corporate formalities, such as maintaining corporate priorities.
- Avoid commingling of assets.
- Adequately capitalize the corporation and insure against loss.

The Exceptions: Statutory

- Transferee liability: Corporate assets improperly transferred to shareholders at a time that the corporation is insolvent.
- Impermissible distributions: §500 of the Corporations Code.

Doing business in another state without qualifying to conduct business in that state.

Common law doctrine of piercing the corporate veil: Observe corporate formalities and adequately capitalize or insure and don't commingle. Note that formalities are reduced in the case of a California Close Corporation.

Agreements, which control the management and ownership of the corporation indicate employment agents can secure management of the corporation and make the corporate ownership very unattractive because of the obligations imposed on the corporation as a consequence of these agreements. [Also consider employee benefit and deferred corporation plans.]

Consideration should be given in having shareholder agreements at least have the objective of acquiring the financially troubled shareholder's stock if creditor attempts to attach shares or a shareholder declares bankruptcy. Corporations Code §500 has to apply to redemption agreements - but shareholders could have option to purchase. Probably hybrid arrangements are best: first give the corporation an option to compensation on a redemption notification and if the option is not exercised, give the individual shareholders the option to acquire the interest.

The untold story--why asset protection trusts? Why foreign? Fraudulent Conveyance Issues, Jurisdiction, Judgments Not Enforceable and Flee Clause.

- **Disadvantages:** Costs and Time Commitments.
- **Qualifying the Grantor and Ethical Considerations:** Fraudulent Conveyance Issue, Documentation, Disclosure of Risks, and Financial Burden.
- **Specific Trust Design Features:** Governing Law, Choice of Trustee, Discretionary Powers of Trustee, Protectors and Letters of Wishes, Beneficiaries, Dispositive Provisions, and Irrevocability, Term of Trust, Grantor Trust Status, Incomplete Gift, and Underlying Entities.
- **Choice of Jurisdiction:** Criteria and Preferred Jurisdictions.
- **Attacking the Asset Protection Trust:** State, Foreign Trust Jurisdiction and Foreign Investment Jurisdiction Attacks, Availability of Information to Creditor, Contempt of Court, Criminal Sanctions, and Exposure of Attorney.

- **United States Tax Issues:** Estate, Gift and Income Tax, Grantor Trust Status, Incomplete Gift, Filing of Form 709, Foreign Trust Status, Internal Revenue Code section 1491, Proposition 13 Reassessments, Internal Revenue Code section 1034 Rollover, and Mortgage Interest Deduction.

United States Reporting Requirements include reporting at Time of Transfer, Annual Reportings, and Filings by Trustee.

Asset Protection

- Fraudulent Transfer Rules
- Bankruptcy Rules
- Discretionary Distribution Provisions
- Support Trusts
- Spendthrift Clauses
- Powers of Appointment
- Disclaimers
- Terminating or Converting Beneficial Interests
- Duration of Trusts
- Jurisdiction

[Questions? Comments? Please contact us by telephone or e-mail...](#)

Estate Planning, Probate and Trusts involve complex areas of law. Individual circumstances must be considered before any advice can be given. The general information above is not to be construed as legal advice, which can only be given after consideration of the unique facts of each matter. Please seek the advice or counsel of your attorney, financial advisor or CPA, as it may be appropriate.

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About the Author...

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- Founder, *WealthPLAN*, 30 years of experience in Tax, Estate-Planning Probate, Trust Administration and Litigation
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A Note from Frank Doyle:

I have been working in this area of law for over thirty years.... I am a member of the *State Bar of California* and certified by the *Cal Bar* as a legal specialist in Taxation Law and Probate, Estate Planning and Trust Administration. I am also an educator and I enjoy teaching and sharing the stories of the challenging legal conundrums that I have solved in my practice over the years. I remember it well; I walked in the door and told my wife, "I quit my job today". She looked at me (holding our 6-week old son) and said, "What are we going to do?" It was at that point that I decided to break out on my own and start my estate planning practice. I hit the road and began to set up the alliances, a network of associates and the expertise to build a thriving international estate planning practice.

Over the years, I have continued to teach law school and present *MCLE* courses nationwide. I was frustrated with the fact that I have never found the information that would allow an attorney to capture the basics of developing and expanding a thriving estate planning practice, so I have created them for you now. I am the founder of *WealthPLAN* and bring over 30 years of experience in tax, estate planning, litigation, probate and trust administration. I have taken all of my experiences and legal expertise to create the *Advanced Legal Training Institute*, foundation course entitled, *Integrated Estate Planning Seminar Series (I-IV)*. This set of 17-AudioCDs include over 30 hours of legal information that will give you a jump start to get yourself into this lucrative and growing legal niche. I have taken the best ideas from all of my presentations, case studies and professional experience to provide you with a step-by-step program to support our aging population. I am now working with some of the children and grandchildren of my original clients. The *Advanced Legal Training Institute* tapes and workbooks offer checklists, templates, forms and articles to provide an in-depth educational experience for attorneys and other estate planning professionals. *P.S.* My 6-week old son, John, is now grown and a practicing attorney himself.

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