ASSET PROTECTION PLANNING FOR THE FAMILY BUSINESS OWNER

Strategic use of multiple types of entities and trusts to own and protect closely held family business holdings and related investments.

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MARIO A. MATA

Mario A. Mata, a business and estate planning attorney, came to Dallas after having established himself as a nationally recognized authority on international trusts and related wealth preservation planning strategies for high net worth individuals and their families. Mr. Mata is a graduate of the University of Texas School of Law in Austin where he received his law degree in 1978. Prior to that, Mr. Mata graduated from the University of Texas School of Business where he received his BBA in Accounting with Honors in 1976.

Mr. Mata has experience in all aspects of business, estate and tax planning for high net worth individuals and families including strategies to efficiently transfer family business interests and personal wealth, both during lifetime and at death, to existing and future generations. However, Mr. Mata is best known for his use of both domestic and international integrated wealth preservation structures to protect assets and family wealth against potential legal claims and other threats to wealth common in today's litigious society or for use as an alternative to problematic pre-nuptial agreements. Mr. Mata's areas of practice include:

- Domestic and International Trusts and Related Wealth Preservation Planning for Professionals, Executives, Business Owners and High Net Worth Individuals and Families.

- Business and Estate Planning including formation of domestic and offshore family limited partnerships, limited liability companies, Trust Planning including use of Dynasty Trusts, Life Insurance Trusts, Children's Trusts, and related estate planning strategies.

- International Business Tax Planning including foreign entity formation.

- Pre-Marital Wealth Preservation Planning.

Mr. Mata is a member of the State Bar of Texas, the New York State Bar Association, and served as Vice-Chair of the Asset Protection Planning Committee of the American Bar Association from 2001 to 2009. Mr. Mata was licensed as a Certified Public Accountant (1981-1985) and was board certified in Commercial Real Estate by the Texas Board of Legal Specialization (1991-1999). Mr. Mata also served on the ALI-ABA Estate Planning Advisory Committee from 2008 through 2010.

Mr. Mata is a frequent speaker on domestic and international wealth preservation strategies and related structures having made presentations at over 250 legal and tax seminars throughout the United States, Canada and Europe including the American Bar Association's Estate Planning Symposium, the Advanced Estate Planning Conference of the Texas Society of CPA's, the International Trusts Congress in London, the Society of Trust and Estate Practitioners in Zurich, Switzerland, and numerous other business, tax and estate planning conferences. Mr. Mata is also a contributing author to the American Bar Association's book *"Asset Protection Strategies: Planning with Domestic and Offshore Entities"* and has also contributed articles published in *Texas Lawyer* and *The Practical Tax Lawyer.*

IN THE NEWS:

- Recognized in August, 2009 by **Texas Monthly Magazine**
  Five Star Awards for Best in Client Satisfaction Wealth Manager - Trust Planning

- Interviewed and Quoted ***"Families Increasingly Turn to Trusts to Protect Assets, Inheritances from Ex-Spouses"*** **Wall Street Journal**, September 22, 2005.

- Featured in July, 2006 by Forbes In-Flight Radio & Sky Radio as one of ***"America's Premier Lawyers."***

LEGISLATIVE ACCOMPLISHMENTS:

- Redrafted the Texas Revised Limited Partnership Act and the Texas Limited Liability Act in 2007 for the purpose of enhancing the wealth preservation benefits of such structures for estate planning and wealth protection purposes.

SELECTED PUBLICATIONS:

- Mata, Mario A. and Marco Gantenbein. Swiss Annuities and Life Insurance: Secure Returns, Asset Protection, and Privacy. Hoboken, NJ: John Wiley & Sons, Inc., 2008.

SELECTED PRESENTATIONS:

Asset Protection Strategies for ILITs and Their Insured including Protecting Against Attempts to Pierce an ILIT
ILITs: Drafting & Administering Irrevocable Life Insurance Trusts
ALI-ABA (American Law Institute – American Bar Association)
Teleconference and Live Video Webcast – December 10, 2007

Playing Defense: What Estate Planners Need to Know About Asset Protection
42nd Annual Southern Federal Tax Institute
Southern Federal Tax Institute
Atlanta, Georgia – October 4, 2007

Asset Protection Planning for the Family Business Owner
Estate Planning for the Family Business Owner
ALI-ABA (American Law Institute – American Bar Association)
San Francisco, California – July 12, 2007; Chicago, Illinois - July 21, 2006
Boston, Massachusetts - July 15, 2005; Santa Fe, New Mexico - July 24, 2004

Wealth Protection Planning in Today's Litigious Society
Asset Protection Planning Update
ALI-ABA (American Law Institute – American Bar Association)
Teleconference and Live Video Webcast – June 26, 2007

Premarital Planning Without a Premarital Agreement
Business Valuation, Financial, and Tax Issues Affecting Divorce
American Academy of Matrimonial Lawyers, Illinois Chapter Annual Conference
Chicago, Illinois – January 16, 2006

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By: Mario A. Mata

I. INTRODUCTION

There are multiple tax and legal issues that should be considered when selecting an entity for a proposed business operation or investment. Typically, the tax consequences of the proposed structure and the limited liability available to the owners of the structure are the principal considerations taken into account. However, there are multiple ***non-tax*** issues that should also be considered by a client's legal advisor when selecting an entity or structure to fulfill the client's immediate goals. While the tax and legal issues are significant, serious consideration should also be given to the long-term non-tax issues and estate planning opportunities that a successful entrepreneur will regret not having planned for if not addressed when the entity and/or structure was designed and implemented.

As with any legal planning, one must plan for the unexpected. Thus, when choosing a legal entity or structure for the client, it is important that the legal advisor take into account unexpected contingencies, particularly personal marital and creditor issues that might arise in the future. This paper will focus on the planning opportunities available to address such issues with comprehensive business entity planning.

II. ADDRESSING THE NEED FOR LONG-TERM LIFETIME PLANNING

A typical entrepreneur is typically familiar with the issues that he or she seeks to have addressed in selecting a business entity for a proposed venture. Those factors, which are described in more detail in Article III below, usually include the desire for limited liability of the owners and favorable tax treatment at both the entity level and the shareholder-owner level. In most cases, attorneys are successful in providing the client with exactly what the client requested, an entity that meets all of the foregoing requirements. Yet, if the entity is successful, particularly if it enjoys a substantial appreciation in net worth and income, the client will eventually seek counsel from an estate planning attorney accustom to dealing with multiple wealth preservation issues that are likely to arise from the client's increasing wealth. What the planner often finds is that the successful entity is typically wholly owned by the entrepreneur in the form of a corporate entity, often an S corporation. Yet, the client's wealth preservation planner is asked to "spread the wealth," so to speak, amongst family members without incurring any additional tax liability, while at the same time structuring the existing entity to minimize estate taxes upon the client's death, or minimize the tax ramifications of a sale of the business or entity prior to that time. Unfortunately, most client's and many of their advisers are too quick to focus on the short-term goals of the client without considering the very significant long-term wealth preservation and wealth transfer benefits associated with addressing all of the foregoing issues at the time that the entity is first established, and not after it has become successful, thus complicating planning possibilities and probably increasing the tax ramifications of any subsequent planning.

In addition to the usual "choice of entity" issues described in Article III below, there are significant long-term wealth preservation and transfer issues that should be addressed, or at least suggested, to a client undertaking a new business endeavor. For example, a client, and if married, the client's spouse, may want to consider addressing some of the following issues:

- **Wealth Transfer Planning** – While no one can predict the ultimate fate of the estate tax, one must nevertheless assume that the estate tax will continue in effect, particularly for larger estates. Therefore, the client and the client's advisors should seriously consider the benefits associated with naming the client's children and descendents as partial, if not significant owners of the proposed business venture.

- **Protection From Future Spouses** – If the client is single, or if married, the client's children will hopefully marry and stay happily married while producing blue chip heirs to follow in their grandfather's footsteps. In reality, one cannot ignore the fact that a slight majority of all marriages in the United States eventually end in divorce. A divorce involving children often results in bitterness that affects those children. Therefore, a client and the client's advisors should seriously consider the benefits of a legal structure, including the ownership of interest in the structure, which will protect the client and the client's descendents from the claims of future spouses and often themselves.
- **Asset Protection** – This author's experience has found that most Texas practitioners will utilize a Texas limited partnership to organize a client's family limited partnership. While Texas law is well suited to achieve the estate planning goals of such planning, the selection of Texas as the domicile for a family limited partnership does

very little to protect the client's interest in the family limited partnership from the claims of creditors. Therefore, the client and the client's advisors should seriously consider the benefits of organizing their limited partnership or limited liability company in a jurisdiction that offers law, either statutory or case law, which protects the ownership interest of the client or the client's descendents in the family business structure.

- **Choice of Ownership** – While the advantages of spreading the ownership of a proposed entity amongst family members is obvious, particularly when including the client's children and other descendents, a client would typically be reluctant to share control of the resulting legal structure with other family members, particularly minors. Moreover, a client should be rightfully concerned with the possibility that his or her children and their descendents may not have the maturity or experience necessary to properly manage their ownership interest in a proposed structure, particularly if the entity begins to make significant cash distributions to the client's descendents. This is one of the reasons why clients often are reluctant to place ownership of an entity in the names of their children. However, this problem can easily be solve through proper planning, typically by having the ownership interest associated with the client's children owned by a domestic trust, established for the benefit of those children, where the trustee will typically disburse only such funds as are required by the client's descendents as is reasonably necessary for their health and support, while investing the remaining funds in the trust for the benefit of the long-term needs of trust beneficiaries.

Regrettably, many clients and their advisors do not consider any of these long-term lifetime issues into account when planning their business structure. When the foregoing issues finally become relevant, usually after the business has become extremely successful, the structure originally selected by the client and advisor may not be ideal to accommodate the long-term lifetime goals of the client as the success of the entity continues. It is precisely for this reason why, in this author's opinion, it is essential that the client's advisors take into account, in addition to the short-term goals of the client, the long-term lifetime goals of the client and his entire family, include wealth transfer issues, which will clearly become more significant to the client and his family as the business venture becomes more successful. Unfortunately, failure to do so can often result in the client seeking long-term lifetime strategies at a time when undertaking such strategies in the existing business structure may have prohibitive tax consequences.

III. SUMMARY OF CHOICE OF ENTITY ISSUES

This section of the paper provides a brief summary of various business entities available to parties who desire to acquire, own, operate, or develop a business enterprise or investment, and discusses factors relevant to the decision of the best entity for a particular situation. Although tax considerations are usually very important in the selection process and will be highlighted in this paper, there is not an exhaustive treatment of tax issues. However, because federal income tax pass-through treatment is required by most clients, this paper places much greater emphasis on partnerships and limited liability companies than on other entities.

A. Important Factors in Selecting the Business Entity.

The basic factors that typically influence the selection of the ownership entity include:

1. **Formation and Maintenance Requirements**: The ease and expense of forming and maintaining the entity;
2. **Extent of Liability**: The extent to which the owners are liable for the obligations of the business;
3. **Management and Control**: The extent of control desired by the owners;
4. **Transferability of Interests**: The extent and ease by which an ownership interest in the entity may be transferred;
5. **Legal Flexibility**: The extent to which the actions of the owners of the business are governed and limited by law (and their ability to contractually vary that result) and the ease with which the form of business can be changed;
6. **Continuity of Existence**: The extent to which the owners desire that the entity have continuity of existence;
7. **Methods for Getting Money Out**: The key issue for many owners -- when and how do I get paid;
8. **Tax Considerations**: The tax treatment of the entity, its owners and employees; and
9. **Asset Protection**: The ability of owners to protect their ownership interest from unforeseen creditor attachment.

This paper tests the more important entity forms against these factors, and separately discusses some risk management issues.

B. Summary of Entities Commonly Used by Business Persons.

This Section provides a brief, rudimentary summary of the forms of ownership used with varying frequency. Although some of the entities generally are not preferred under the current state of the law, for reasons that will be explained (usually, tax and liability reasons), each is mentioned because a unique combination of factors important to a particular client may lead to use of a form that, in more typical circumstances, would be considered inadvisable. However, the extended discussion later in the paper primarily involves a comparison of partnerships (especially limited partnerships), limited liability companies and, mainly for illustration, subchapter S corporations.

1. Sole Proprietorships.

In a sole proprietorship, the business is conducted by an individual who owns all of the property. There are no formal requirements for a sole proprietorship to exist other than, perhaps, dedication by the proprietor of a portion of his or her individual assets to a specific business purpose and, if appropriate, the filing of an assumed business name certificate.

2. General Partnerships and Joint Ventures.

A general partnership is, by statutory definition, an association of two or more persons to carry on a business for profit as co-owners. A joint venture is, essentially, a general partnership with a limited purpose (which has led to its widespread use for real estate project ownership). Therefore, to the limited extent they are discussed in this paper, these two entities are considered the same. A general partnership is not taxed as a separate entity from its partners.

3. Limited Partnerships.

A limited partnership (sometimes "LP's") is a partnership that has one or more general partners (who are liable for the obligations of the partnership) and one or more limited partners (liable only to the extent of their actual or committed investment in the partnership). Like general partnerships, a limited partnership is not taxed as a separate entity from its partners. Because the creation of a limited partnership involves the filing of a certificate with the state, that form tends to be somewhat more formal than general partnerships, although a limited partnership can be created by oral agreement.

4. Registered Limited Liability Partnerships.

A registered limited liability partnership ("LLP") is a special type of general partnership in which, in certain circumstances, some LLP partners are not liable for debts and obligations of the partnership that arise from errors, omissions, negligence, incompetence, or malfeasance committed without the knowledge of the protected partner by another partner or employee not supervised by the protected partner. This has been described as "a dramatic break from tradition, . . ." in A. Bromberg and L. Ribstein, Bromberg & Ribstein on Partnership, (1988) [hereinafter "BROMBERG AND RIBSTEIN"], page 5:83, describing the creation of an LLP under the Texas Uniform Partnership Act, TEX. REV. CIV. STAT. ANN. art. 6132b, now found in Section 152 of the Business Organization Code.

Note that a Texas limited partnership can also be an LLP, which can give some measure of additional protection to a general partner when there are several active general partners. That is a risk management consideration for the general partners.

Now, most states have followed Texas' lead and now have LLP statutes, and there is in process drafting of a national LLP Act.

5. Corporations.

A corporation is a legal entity formed under state law that provides its owners -- the shareholders -- with limited liability. The law treats corporations as having a personality and existence distinct from that of its owners and, accordingly, taxes them as entities separate from their shareholders.

6. S Corporations.

An S Corporation (sometimes "S Corp") is a so-called "small business corporation" that has made the required election under the Internal Revenue Code of 1986, as amended (the "IRC"), to be treated as having conduit or "flow-through" federal income tax attributes. On non-tax issues, the S Corp is treated the same as other corporations.

7. Limited Liability Companies.

A limited liability company (sometimes "LLC") is a non-corporate entity organized under a state enabling statute that affords its owners -- called "members" -- the limited liability of a corporate shareholder while also providing the opportunity for the flow-through tax treatment of a partnership. This dual benefit has made LLC's very popular in many business contexts, including real estate.

C. Check-the-Box Classification.

In Notice 95-14, 1995-14 IRB 1, the IRS announced it was considering simplifying the

classification of unincorporated business associations by adopting a "check-the-box" classification election. On May 9, 1996, the IRS issued its proposed "check-the-box" regulations that implemented the proposal discussed in Notice 95-14. The regulations were finalized on December 17, 1996 and became effective on January 1, 1997. Under the regulations, the first step in the classification process is to determine whether there is a separate entity for federal tax purposes. The regulations provide that certain joint undertakings that are not entities under local law may nonetheless constitute such entities for civil income tax purposes; on the other hand, not all entities formed under local law are recognized as separate entities for federal income tax purposes. For example, a tenancy in common may create a separate entity for federal income tax purposes if the individual carries on a trade or business.

If the organization is recognized as a separate business entity, it is neither classified as a trust or a business entity. The regulations provide that trusts generally do not have associates or an objective to carry on business for a profit. There is no change to the classification of trust and business entities under current law.

Next, the regulations provide that certain entities are classified as corporations, including any entity formed as a corporation under state law, joint stock companies, insurance companies, organizations that commerce banking, banking institutes, organizations wholly-owned by the state, organizations that are taxable as corporations under any other provisions of the Code, such as REITs, and any foreign business entities that are specifically mentioned in the regulations.

Business entities other than corporations or trusts can elect their classification. If the entity has at least two members, it can be classified either as a partnership or association taxable as a corporation. An election must be filed within the first 75 days of a tax year to be effective as of the beginning of that tax year. The election is made on Form 8832 – Entity Classification Election. After that period, the election is effective on the date the election is made. A copy of the election would have to be included with the entity's first tax return. If the entity with two or more members fails to file an election, the default classification would be a partnership.

If the entity has only a single member, it will be classified either as a sole proprietorship or an association taxable as a corporation if the one member is an individual, or as a branch or association taxable as a corporation if the one member is a corporation. If the business entity fails to file an election, its default classification would be either a sole proprietorship or a branch.

An eligible entity that makes an election to change its classification cannot again change its classification during the 60-month period following an effective ate of its first change in character. Making an initial election does not count for purposes of this test. For example, if a business entity elected to be taxed as a partnership, it could at any time elect to be taxed as a corporation, but then could not change that election for a 60-month period.

D. Non-Economic General Partner in Limited Partnership.

Effective September 1, 2003, the Texas Revised Limited Partnership Act, now known as the "Texas Limited Partnership Law" under the new Business Organization Code, was amended to permit general partners to acquire interests in their entity without (i) making a contribution to the entity or (ii) assuming an obligation to make a contribution to the entity. In addition, the act was amended to provide that a general partner may be admitted to the entity without acquiring an interest in the entity. ***In other words, a general partner in a Texas limited partnership is not required to have an economic or other ownership interest in the limited partnership.*** In each instance, the limited partnership agreement must specifically authorize such admission of the general partner. In addition, in the case of a non-contributing general partner, that the general partner may be the sole general partner. Additionally, a non-interest owning general partner may be the sole general partner on the limited partnership. All of the foregoing provisions were incorporated into what is now Section 153.151(c) of the Texas Business Organization Code.

The concept of a non-economic general partner in a Texas limited partnership introduces several important planning opportunities for the use of Texas limited partnerships within the state. However, the use of multiple limited partnerships to acquire smaller income-producing properties can result in a tax compliance nightmare if each limited partnership is treated as a separate entity for federal income tax reporting purposes. However, the concept of a non-economic general partner, that is, a general partner that does not have an economic interest in the limited partnership, allows the use of a limited partnership in much the same way that a single member limited liability company is used for federal income tax purposes. This occurs because a general partner, without an economic interest in the limited partnership, is not treated as a partner for federal tax purposes.

Not surprisingly, there is a significant amount of case law and IRS ruling which clearly provide that

merely calling someone a "partner" in an agreement under state law does not necessarily mean that the person or entity is a "partner" for federal tax purposes. For example, in a 1975 General Counsel Memorandum ("GCM"), the Internal Revenue Service stated that the "mere fact" a person is "characterized as a general partner in the partnership agreement and in the certificate of limited partnership is not binding for federal income tax purposes."[1] Likewise, in Revenue Ruling 75-31, 1975-1C.D.10, the Internal Revenue Service held that where a so-called partner had no interest in the entity and would never have an interest in any item of income, gain, loss, deduction, credit or capital of the so-called partnership, nor would it had any beneficial interest in the receipts, investments or other property of the partnership during the operation or upon the liquidation of the partnership, that partner would not be considered a partner of the partnership for federal income tax purposes.

The closest analogy to the non-economic general partner can be found in the concept of a "manager" of a limited liability company. While a manager in a limited liability company may have significant authority, in most cases, virtually complete authority over day-to-day activities, a person's designation as a "manager" of a limited liability company, with significant authority over the company, does not, by itself, render the manager an owner or "member" of the limited liability company. Thus, in a limited liability company with two or more members, the manager would not, under the foregoing circumstances, be treated as a "partner" for federal income tax purposes.

If a limited partnership has a general partner that does not have an economic interest in the partnership, and if the limited partner is a single person, whether it be an individual or another entity, the net effect, for federal income tax purposes, is an entity that has only one partner, hence no partnership, since federal tax law requires two or more partners to constitute a partnership for federal tax purposes. If the limited partnership is treated as an entity with only one partner for federal tax purposes, the entity is eligible to be treated as a "disregarded entity" under the IRS "Check the Box" regulations.

IV. THE PROBLEM WITH S CORPORATIONS

S corporations had been popular with practitioners for many years. From strictly a state legal standpoint, there is no difference in the legal status of a "C corporation" and an "S corporation." Generally speaking, from a legal standpoint, S corporations and their shareholders enjoy the same benefits as their C corporation counterparts. As a result:

- Absent a "piecing the corporate veil" situation, shareholders of an S. corporation generally have complete insulation from liability. Usually, the liability of shareholders is limited to their investment in the S corporation.
- S corporations have the same corporate management structure familiar to most entrepreneurs. The officers of the corporation answer to the board of directors who are elected by the shareholders of the corporation. Shareholders can be involved as board members and/or officers, generally without fear of increased liability exposure. If necessary, in more complicated situations, a voting agreement or other shareholder agreement can be entered into to regulate the corporation's management.
- Subject to security law issues and contractual limitations amongst the shareholders, shares in an S corporation or freely transferable.
- Corporations can have a perpetual existence. Unlike sole proprietorships, and partnerships that do not contractually provide for continuation after dissolution, the removal, death or incapacity of a director, officer or shareholder will not disrupt the continuity of the S corporation.

A. Taxation of an S-Corporation.

While the formation and operation of an S corporation for state law purposes is the same as with a C corporation, a corporation that has elected to be treated as a "S corporation" for federal income tax purposes does so to seek the tax advantage of the pass-through partnership treatment available to an S corporation.

A corporation may elect S corporation status for a current year at any time during the prior taxable year or at any time on or before the 15th day of the third month of the corporation's current tax year. The election must be made with the consent of all shareholders and the timely filing of IRS Form 2553. Failure to timely make the election may result in undesirable, if not catastrophic, adverse tax consequences although the Internal Revenue Service has in recent years exercised its discretion to accept a late filed S corporation election under certain circumstances, typically in the corporation's first year of operation.

If S corporation status is properly elected, and if the rules that must be satisfied for that status to be maintained are observed, the flow through aspects of the basic federal income tax treatment is the same as for a partnership. As a result, there is generally no taxable income on the corporate level. Instead, the income of the S corporation is treated as having been received by the shareholders of the S corporation,

[1] G.C.M. 36, 142 (Jan. 20, 1975)

whether or not that income is distributed to those shareholders, and is thus taxed at the shareholder level.

B. S Corporations are NOT Taxed as Partnerships.

It is easy to see why S corporations are generally thought to be corporations that are taxed as partnerships. If that were a truly accurate statement, S corporations would arguably be the entity of choice in most business planning situations. Nevertheless, the belief that S corporations are taxed in the same manner as partnerships is, to a significant extent, a fallacy that can result in difficult income tax planning situations for the shareholders and their business and estate planning counsel.

1. Non-Cash Distributions are Taxable.

The major difference between LP's and LLC's, on the one hand, and S Corps, on the other, relates to the distribution of property other than cash. Cash distributions do not result in any entity taxation, and the distributee has a tax only to the extent the cash distribution exceeds the distributee's tax basis in his ownership interest. The exception to this rule is if an S Corp has some retained earnings from a period that it or a predecessor was a C corporation. In any event, any entity taxed as a partnership (i.e. general partnerships and most limited partnerships and LLC's) does not treat a distribution of property as a taxable event; however, an S Corp does. Although the S Corp generally is not required to pay any tax itself when it distributes property (unless the property is "tainted" because the property has a C corporation history), the S Corp is required to recognize gain or loss on the distribution of property as if it were sold for its fair market value. As a result, each of its shareholders must recognize an allocable share of the corporation's gain or loss. Because of this difference in taxation, the tax basis and holding period of distributed property in a distributee's hands also is different. A partner has a carryover holding period and takes a basis in the property equal to the lesser of the partnership's tax basis in that property and the partner's tax basis in its partnership interest. An S Corp shareholder has a new holding period and takes a tax basis in the property equal to the property's fair market value.

2. Liquidation or Conversion of S Corporation is a Taxable Event.

After an S corporation has been in operation for several years, it is not uncommon for the successful entrepreneur-owner of the entity to seek the benefits of long-term estate planning and possibly asset protection planning. During the consultation process, it typically becomes obvious that maximizing the estate planning and asset protection benefits sought by the client can best be achieved through and entity other than an S corporation, typically a limited partnership structured as a family limited partnership. However, it is at this point that a second major disadvantage of the S corporation becomes obvious.

The Texas Business Corporation Act and related business statutes permit a corporation, limited partnership or limited liability company to convert from its existing legal form into another form of entity without going through the formality of a liquidation, the distribution of assets, the creation of a new entity and the contribution of the assets to the new entity. Very simply, by filing articles of conversion with the Secretary of State, it is quite a simple process to convert from one form of entity into another. Unfortunately, the ease with which an entity can change its form under Texas law does not equate to comparable treatment for federal income tax purposes. In fact, quite the contrary can be true. Generally speaking, the conversion of an entity classified as a corporation for federal income tax purposes, whether a C corporation or an S corporation, will be treated as a taxable liquidation of the entity. Thus, notwithstanding the common description of an S corporation as a "corporation that is taxed as a partnership" the conversion of an S corporation into an entity classified as a limited partnership for federal income tax purposes will result in the conversion being treated as a taxable liquidation of the corporation. At the corporate level, the corporation will recognize taxable gain as if the corporation had sold all of its assets just prior to the liquidation. The shareholders of the corporation will then be required to recognize taxable income equal to the difference between the fair market value of the assets "deemed" distributed to shareholders and the shareholders basis in the S corporation. Unlike shareholders in a C corporation, shareholders in an S corporation do receive the benefit of an increase in tax basis in their shares that stems from the S corporation's recognition of income at the corporate level. Nevertheless, the fallacy that an S corporation is taxed as a partnership becomes painfully evident when an S corporation is liquidated or is deemed to have been liquidated for federal income tax purposes when converted for state law purposes from a corporation to a limited partnership or limited liability company.

With careful planning, it is possible to legally convert a C corporation or S corporation into a limited partnership for state law purposes without triggering the adverse federal tax consequences associated with the liquidation of a corporation. However, extremely careful tax planning is required if pursuing such a strategy, particularly when it involves an S corporation. Nevertheless, if done properly, it is possible to convert

an entity under state law to a limited partnership while still maintaining the S corporation status that it had before. Unfortunately, it is a fact that a corporation is treated as an S corporation for federal tax purposes that can limit the ability of a wealth preservation planner to maximize the estate planning and asset protection benefits otherwise available with a family limited partnership. As a result, an S corporation that had an extended history and holds appreciated assets typically cannot benefit from the multiple estate and asset protection advantages associated with a family limited partnership since the cost of converting the entity from an S corporation to a limited partnership for income tax purposes could be prohibited.

C. Other Disadvantages of S Corporations.

While still popular with many practitioners, especially accountants who organize entities for their clients, there are other challenges and potential problems associated with doing business as an S Corporation:[2]

(a) S corporations are subject to certain restrictions on the number and type of shareholders they may have. S corporations may not have more than 100 shareholders.[3] Corporations (if not described in I.R.C. § 501(c)(3)), partnerships, certain kinds of trusts and non-resident alien individuals may not be shareholders of an S corporation.[4] LPs are not subject to any of these restrictions.

(b) S corporations are not permitted to specially allocate income, deduction, gain or loss among their shareholders or to make disproportionate distributions to their shareholders. LPs are permitted to specially allocate income, deduction, gain or loss among members within the confines of I.R.C. § 704(b) and make disproportionate distributions to their members.

(c) S corporations may not have more than one class of stock outstanding, although separate voting and non-voting classes of stock are allowed.[5] LPs may have any number or variety of classes or series of membership interests.

(d) S corporations may be subject to certain penalty taxes for built-in gains and excessive passive income.[6] These penalty taxes do not apply to LPs.

(e) On the death of a shareholder or the sale of his or her stock, an S corporation cannot adjust the basis of its assets to reflect the increase in the shareholder's basis in his or her stock to its fair market value at the date of the shareholder's death. If it is classified as a partnership for federal income tax purposes, an LP can elect under I.R.C. § 754 to adjust the basis of its assets upon the death of a member or on the sale of a member's interest in the LP to reflect the increase in the fair market value of the member's interest.

(f) An S corporation shareholder's basis in his or her stock is not increased by his or her share of the S corporation's debts for purposes of deducting S corporation losses. A member of an LP classified as a partnership can include the member's share of the LP's debt under I.R.C. § 752, in the basis in his or her membership interest even though that debt is non-recourse to the member.[7]

(g) An S corporation can inadvertently forfeit its status as an S corporation (e.g., creation of more than one class of stock or the acquisition by a non-eligible person or entity of stock in the S corporation), thus subjecting it to taxation as a C corporation.

(h) A judgment creditor of an S corporation shareholder can seize the shareholder's stock in the S corporation. Thus, in addition to having the obvious problems of a shareholder's creditor now owning shares in the S corporation, the seizure of the shares and transfer of the ownership of those shares to the creditor or other third party in a judicial sale, can place the S corporation

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2 Excerpt from "Guide to Organizing an Operating a Limited Liability Company in California", a report of the Partnerships and Limited Liability Companies Committee of the Business Law Section of The State Bar of California. (1999 Draft Edition.)

3 The American Jobs Creation Act of 2004 increased from 75 to 100 the number of shareholders an S corporation may have for tax years beginning after December 31, 2004. Additionally, one family can elect to the treated as a single shareholder for purposes of applying the expanded shareholder limitation rules.

4 I.R.C. § 1361 (b)(1).

5 I.R.C. § 1361 (b)(1)(D).

6 I.R.C. §§ 1374 & 1375.

7 The ability of a member to deduct losses against his or her basis in the LLC may be limited by the "at-risk" rules contained in I.R.C. § 465.

status of the corporation at risk if the creditor acquiring the shares is not otherwise qualified to be an S corporation shareholder. As a result, the status of the entity as an S corporation for tax purposes can be placed in jeopardy and even terminated as a result of the creditor's actions. Such is not the case with a properly structured LP or LLC where applicable law prohibits a foreclosure of the debtor's interest and instead limits a creditor's remedy to a charging order, described below.

V. DOMESTIC TRUST PLANNING

The domestic trust has been successfully utilized by practitioners as a crucial estate planning and wealth preservation planning tool for decades. Despite restrictions on the ability of a settlor to retain an interest in a trust, a properly structured irrevocable trust, where the grantor has "cut the strings" in terms of benefit and control, has been, and still can be, successfully used to preserve the assets of the grantor for the benefit of his family.

A popular estate planning strategy often involves limited partnership interests that have been gifted to family members. If the family members own the limited partnership interests in their individual capacities, their interests are subject to their own individual creditor claims, although the charging order limitations discussed in this paper certainly provide some protection and relief from such creditor action. However, another insulation of protection for the limited partnership interest can be obtained if the gift of the limited partnership interest is made to an irrevocable domestic trust rather than to the family member directly. There are several advantages to such a strategy.

- **Preservation and Oversight of Interest Gifted to Heir** – The love and affection recited in a gift deed or assignment should not be misconstrued as an endorsement by the parents of a child's ability to manage large some of cash and other assets distributed by a family business entity. By gifting the ownership interest into a domestic trust for the benefit of the family member, a trustee, often a trusted family member, can use his or her best discretion in making distributions to the beneficiary-heir while preserving undistributed funds for the benefit of the future needs of the beneficiary or his or her descendants.
- **Asset Protection Claims Against Children** – If the trust is not involved in any other activity that would subject it to litigation risks, the limited partnership interest transferred to the domestic trust for the benefit of the family member can effectively be protected from the potential creditor claims of the donee family member.
- **Protection From Future Spouses** – Likewise, having the trust own the ownership interest transferred to the domestic trust will protect the donee family member from the claims of future spouses or, if clearly structured as a gift intended to be separate property, from the claims of an existing spouse. This is particularly true in approximately 12 "equitable distribution states" where a divorce court has the power to invade an individual's separate property to award such property to a party in the divorce who the court feels is not at fault in the marriage and will be at an economic disadvantage in attempting to pursue a post-divorce livelihood in light of his or her diminished earnings capacity or net worth. In other words, if a divorce court in such states feels that it is "equitable" to distribute a significant amount of an individual's separate property to the other spouse, such courts are free to do so if it is necessary in order to reach an "equitable" allocation of assets as part of the dissolution of the marriage. Likewise, in many of those same states, a surviving spouse can "elect" to take against a decedent's Will by electing to take a percentage of the decedent's estate in excess of what was provided for in the decedent's Will, even if that should mean invading what is clearly the decedent's separate property in order to fund the "surviving spouse" election.
- **Estate Tax Planning Opportunities** – A properly structured testamentary trust is often provided for in a client's Will for the benefit of the decedent's children or other heirs. While such trusts can and often are drafted to terminate once the beneficiary reaches a certain age, a testamentary trust can also be drafted to last for the lifetime of the beneficiary with the intention that the beneficiary exercise a limited power of appointment, upon his or her death, to leave his or her assets of the estate to such heirs as that beneficiary may elect. If properly structured, such an election can be exercised without risking the possibility that the assets of the testamentary trust will be included in the decedent's taxable estate. Unfortunately, it is in these types of trusts, particularly when a beneficiary can elect to become his own trustee at a particular age, that courts are more likely to find that the trust can be pierced to satisfy creditors or divorce court claims.

While the strategies discussed above assume a simple wealth preservation strategy, designed to protect the

donee from a variety of potential claimants, a domestic trust can be structured to include significant estate tax benefits such as the use of a domestic "dynasty trust," designed to last for generations in a jurisdiction that has abolished or significantly curtailed the Rule of Perpetuities. The benefits are achieved by allocating to the trust a portion of the client's GST exemption to any gifts to the trust.

A. Spendthrift Trust.

One of the most common types of trust used in asset preservation is the spendthrift trust. A spendthrift trust is one that provides by its terms that the interest of a beneficiary in the income or principal of the trust may not be voluntarily or involuntarily transferred or otherwise alienated by the beneficiary, except as provided by the trust instrument. The enforceability of a spendthrift trust is usually recognized by state statute which provides that a settlor may provide in the terms of the trust that the interest of a beneficiary in the income or in the principal or in both may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. A declaration in a trust instrument that the interest of a beneficiary shall be held subject to a "spendthrift trust" is usually sufficient to restrain voluntary or involuntary alienation of the interest by a beneficiary.

Historically, since 1959 until recently, the general rule involving the protection of a beneficiary's interest in a spendthrift trust was found in the Restatement of the Law, 2d, Trust, published in 1959 by the American Law Institute.

1. Restraint on Alienation of Income.

The Restatement of Trusts, 2d, provided in §152(1) the right of a beneficiary to receive income from a spendthrift trust was specifically protected from alienation. Specifically it provided that:

> (1) Except as stated in §§ 156 and 157 [of the Restatement], if by the terms of a trust the beneficiary is entitled to the income from the trust property for life or for a term of years and it is provided that his interest shall not be transferable by him and shall not be subject to the claims of his creditors, the restraint on the voluntary and involuntary transfer of his right to the income accruing during his life is valid.
> (2) A trust in which by the terms of the trust or by statute a valid restraint on the voluntary and involuntary transfer of the interest of the beneficiary is imposed is a spendthrift trust.

The sole exceptions to the general restraint on alienation of §152 were found in §156 and §157. Section 156 relates to the situation where the settlor is also beneficiary of the trust, in other words, a "self-settled trust" which, to this day, is not favored by the Restatement, although now recognized in eight states. The second general exception to the general rule of §152 is found in §157 which relates to particular classes of claimants who can reach the interest of the beneficiary of a spendthrift trust. Such claimants generally fall into the category of the wife or child of the beneficiary who pursue a claim for spousal or child support or alimony.

2. Restraint on Alienation of Principal.

While §152 of the Restatement of Trusts, 2d addressed a restraint on the alienation of income, §153 addressed the restraint on alienation of principal. Specifically, §153 of the Restatement 2d of Trusts provided that:

> (1) Except as stated in §§ 156 and 157, if by the terms of a trust the beneficiary is entitled to have the principal conveyed to him at a future time, a restraint on the voluntary or involuntary transfer of his interest in the principal is valid.
> (2) If the beneficiary is entitled to have the principal conveyed to him immediately, a restraint on the voluntary or involuntary transfer of his interest in the principal is invalid.
> (3) If the principal is not to be conveyed to the beneficiary during his lifetime, a restraint on the voluntary or involuntary transfer of his interest in the principal is invalid.

The two referenced exceptions to the general rule are identical to those found in §152. Thus, subject to the exceptions of §§ 156 and 157, a trust beneficiary was entitled to have the beneficiary's interest in the principal of the trust protected against voluntary or involuntary transfer if by the terms of the trust the beneficiary was entitled to have principal conveyed to him or her at a future time. Such a principal would essentially ensure that the corpus of the trust that, at some future point in time, might become available to the beneficiary, was protected against alienation prior to the occurrence of that event.

Under a discretionary trust, the beneficiary is entitled only to the income or principal that the trustee,

in her discretion, shall distribute to him. G. Bogert, The Law of Trusts and Trustees § 228 (2d ed. 1979). The beneficiary of a discretionary trust cannot compel the trustee to pay him or to apply for his use any part of the trust property, nor can a creditor of the beneficiary reach any part of the trust property until it is distributed to the beneficiary. Id.

B. Discretionary Trust.

A discretionary spendthrift trust provides even greater protection to its beneficiaries than a regular spendthrift trust. In a discretionary trust, the trustee has sole and absolute "*discretion*" to decide the amount and the timing of income or principal distributions to the beneficiary. Typically, as long as property is held in trust and is subject to the terms of a spendthrift provision, the general rule is that property may not be reached by the creditors of a beneficiary of that trust. However, once the proceeds are distributed to the beneficiaries, they escape the protection of the clause and may be reached by creditors.[8] However, the broad discretionary powers of a trustee under an agreement which empowers the trustee full and absolute discretion in making distributions to beneficiaries constitutes a further restraint upon the ability of the beneficiaries of the trust to assign or in any manner alienate the income or the principal of the trust, and represents as well a further immunity from judicial process.[9] Although the courts will recognize that all property of a debtor shall be subject to reach in proper time and manner by his creditors, save only such property as may be legally exempt, the courts will generally not extend this policy to income of discretionary trust funds, which are held in trust for the ordinary and necessary living expenses of the beneficiary, at least until such funds are actually received and held by the beneficiary. Such income does not constitute "property" within the normal meaning of state statutes defining property which is available for execution.[10]

In First Northwestern Trust Co., *infra*, the Eighth Circuit Court of Appeals declined to allow the claim of the Internal Revenue Service to reach the interest of beneficiaries in a family trust where the trustee had broad discretionary powers. The court held that the rights of the beneficiaries were contingent upon the discretionary authority of the trustee. The trust agreement gave the trustee the authority to distribute the trust funds in unequal amounts, and the agreement specifically provided that the trustee was only obligated to disburse "*such amounts as in the sole discretion of the Trustee as necessary, reasonable and proper, to such members of the [settlor's] family requiring such funds upon proper proof of such need to the satisfaction of the Trustee* . . . The court found that there was no identifiable or ascertainable interest or right in the income until those two contingencies were met.

C. Disadvantages of Domestic Trust.

Despite their relatively good track record for asset protection purposes, there are two significant problems associated with the use of domestic trusts.

1. Rule Against Self-Settled Trust.

One of the reasons why so many domestic trusts are established for the benefit of a grantor's family is directly attributable to statutes found in most states prohibiting a settlor from establishing a valid spendthrift trust for his own benefit. For example, in Texas the prohibition against self-settled trust is found in §112.035 of the Texas Property Code. It provides that, *"If the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of his beneficial interest does not prevent his creditors from satisfying claims from his interest in the trust estate."* While the foregoing language prohibits a settlor of a trust from protecting his interest in the trust against his creditors, some consolation can be taken by the settlor in the fact that language such as the foregoing has been regularly interpreted to mean that a creditor can only reach the settlor's interest in the trust. Thus, if the settlor is entitled to receive a distribution of income from the trust, a creditor will be successful in reaching such income distributions. However, if properly structured, a self-settled trust may be able to protect its remaining corpus, theoretically for the benefit of future contingent beneficiaries of the domestic trust.

2. Domestic Trusts Are Subject to U.S. Jurisdiction.

The fact that a domestic trust is located within the United States makes it a natural and easy target for creditor lawsuits. There are a variety of reasons why a settlor might want to avoid locating a trust within the United States.

a. Personal jurisdiction.

If a domestic trust is already here, it is impossible for it to avoid becoming a target of litigation. Unlike a foreign situs trust with no presence in the United States, it is impossible for a domestic trust to claim that a court in the United States does not have jurisdiction over its assets or the trustees. Thus, even if a lawsuit is

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8 First Northwestern Trust Co. v. IRS, 622 F.2d 387 (1990).

9 First Northwestern Trust Co. v. IRS, *infra* at 391.

10 First Northwestern Trust Co. v. IRS, *infra* at 392.

frivolous, the trustees of the domestic trust have no choice but to incur the expenditures necessary to defend the trust.

b. Confidentiality.

Secrecy should never be a necessary part of a successful wealth preservation plan. Nevertheless, the high financial profile of most clients involved in wealth preservation planning makes confidentiality an important goal of many potential settlors. If a domestic trust is sued, literally all of its records and communications, except items privileged by law, are subject to discovery.

3. Trust Assets Are Subject To Court Control.

A domestic trust, its trustees, and its assets, are subject to the whims of state and federal judges. In some cases, U.S. courts have been known to instruct trustees to take actions which are clearly in contravention of the well-documented wishes of the settlor.

VI. ATTACKS ON SPENDTHRIFT TRUSTS BY CREDITORS, DIVORCE COURTS, AND THE IRS

As indicated above, the protection afforded the beneficiary's interest in a non self-settled spendthrift trust is provided by statute in most states and common law in the remaining states. It is a concept that, until recently, has been unchanged since the initial adoption of the English common law rule. However, a small but growing number of disturbing cases reflect a growing willingness by the courts to disregard the spendthrift protections provided by state law thus allowing a creditor or divorcing spouse to reach the assets of a spendthrift trust.

To make matters worse, the concepts that have developed in case law which allow the piercing of a spendthrift trust have now actually found their way into the newly issued Restatement of Trusts, 3d, issued in 2003, and the recently proposed Uniform Trust Code. While trust and estate practitioners can take note of this disturbing trend when drafting their testamentary or inter vivos trust documents, the problem typically arises in trusts that have been in existence for several years or were established prior to the recent disturbing trend in case law that has been recently codified into the Restatement of Trusts. With respect to those preexisting trusts, many unsuspecting beneficiaries are likely to place themselves in a position where their spendthrift trusts, previously thought to be immune from creditor or divorce court attack, are suddenly successfully pierced by third-party claimants. Of course, in some cases, the error occurred when the trust document was first drafted without taking into account the rights that creditors have had for decades. In the discussion below, several examples of faulty drafting or trust operation which resulted in the piercing of the trust, will be discussed.

Although the Restatement of Trusts 3rd does not have the force of law, it is intended to reflect the state of generally accepted legal principals throughout the United States. The fact that the Restatement of Trusts 3d has adopted §60 is indicative of what the Restatement felt was a trend in case law to allow for the expanded ability of a creditor to reach the interest of a trust beneficiary notwithstanding longstanding spendthrift protections that have existed in law of all 50 states for decades. In fact, many of the principals supported by the Restatement of Trusts 3rd can now be found in the newly drafted and proposed Uniform Trusts Act which has already been adopted in a handful of states.

A. Restatement of Trusts, 3d.

The 3d Restatement of Trusts, issued in 2003, generally acknowledges the validity of a spendthrift trust, subject to certain exceptions, although it specifically provides that a "restraint on the voluntary and involuntary alienation of a beneficial interest retained by a settlor of a trust is invalid." Restatement §59 does provide that the interest of the beneficiary in a valid spendthrift trust can be reached in satisfaction of an enforceable claim against he beneficiary for:

(a) support of a child, spouse, or former spouse; or
(b) services or supplies provided for necessities or for the protection of the beneficiary's interest in the trust.

However, the most significant change in the Restatement's protection of spendthrift interest in trust is found in the new §60 of the Restatement 3d. It provides that:

> Subject to the rules stated in §§58 and 59 (on spendthrift trusts), if the terms of a trust provide for a beneficiary to receive distributions in the trustee's discretion, a transferee or creditor of the beneficiary is entitled to receive or attach any distributions the trustee makes or is required to make in the exercise of that discretion after the trustee has knowledge of the transfer or attachment. The amounts a creditor can reach may be limited to provide for the beneficiary's needs, or the amounts may be increased where the beneficiary either is the settlor or holds the

discretionary power to determine his or her own distributions.

1. Scope of New Section 60.

In the Comments to the rule, the Restatement states that the rule stated in §60 and its commentary allows a beneficiary's assignee to receive discretionary distributions to which the beneficiary would otherwise be entitled, and allows creditors of the beneficiary to attach his or her discretionary interest. The rule does not apply if the beneficiary's interest is subject to a valid spendthrift restraint under the rules of §58 unless the situation falls within an exception under § 59.

Section 60 recognizes special rules for discretionary interests retained by a settlor and for trusts in which the beneficiary, as trustee or otherwise, holds the discretionary authority to determine his or her own distributions. These new rules (in Comments *f* and *g*, respectively) expand the amount such a beneficiary's creditors may reach.

The rules stated in the new Restatement §60 and its commentary apply to whatever extent a beneficiary's interest is discretionary. Thus, if the beneficiary is entitled to all of the trust's net income but only to principal in the trustee's discretion, the Section applies to the provision for invasion of principal but not to the income interest. Also, the Section prevents the trustee not only from making payments to the beneficiary but also from making "distributions" by applying funds directly for the beneficiary's benefit contrary to the rights of the transferee or creditor.

2. Rights of Creditors.

In Comment *e* to §60, the Restatement states the rule that, in the absence of a valid restraint on involuntary alienation (under §58 or a statute), the creditors of the beneficiary of a discretionary interest may attach that interest and may subject it to the satisfaction of enforceable claims by appropriate process as described in §56, Comment *e*. The interest, however, is not subject to execution sale. Furthermore, if an expressed or implied purpose of the discretionary interest is to provide for the beneficiary's support, health care, or education, in establishing the portion of each distribution allocated to the payment of claims the court is to take account of the beneficiary's actual needs in maintaining a reasonable level of support, care, and education.

If the trustee has been served with process in a proceeding by a creditor to reach the beneficiary's interest, the trustee is personally liable to the creditor for any amount paid to or applied for the benefit of the beneficiary in disregard of the rights of the creditor, in the absence of a valid spendthrift provision (§58) applicable to the creditor (see §59).

3. Creditor Ability to Compel Discretionary Distributions.

In Comment *e* to Restatement §60, the Restatement acknowledges that a transferee or creditor of a trust beneficiary cannot compel the trustee to make discretionary distributions if the beneficiary personally could not do so. It is rare, however, that the beneficiary's circumstances, the terms of the discretionary power, and the purposes of the trust leave the beneficiary so powerless. The exercise or nonexercise of fiduciary discretion is always subject to judicial review to prevent abuse. What might constitute an abuse, however, is not only affected by the extent of the trustee's discretion, standards applicable to its exercise, and purposes of the trust, but also by the beneficiary's circumstances and the effect discretionary decisions will have on the discretionary beneficiary and on others in relation to the fulfillment of trust purposes.

The rights of a discretionary beneficiary's assignee or creditor are also entitled to judicial protection from abuse of discretion by the trustee. On the other hand, a trustee's refusal to make distributions might not constitute an abuse as against an assignee or creditor even when, under the standards applicable to the power, a decision to refuse distributions to the beneficiary might have constituted an abuse in the absence of the assignment or attachment. This is because the extent to which the designated beneficiary might actually benefit from a distribution is relevant to the justification and reasonableness of the trustee's decision in relation to the settlor's purposes and the effects on other beneficiaries. Thus, the balancing process typical of discretionary issues becomes, in this context, significantly weighted against creditors, and sometimes against a beneficiary's voluntary assignees.

4. Compelling Distributions Where Beneficiary Holds Discretionary Power.

Sometimes a beneficiary is trustee of the discretionary trust, with authority to determine his or her own benefits. In such a case, a rule similar to that of Comment *f* applies, with creditors able to reach from time to time the maximum amount the trustee-beneficiary can properly take. As in other nonsettlor-beneficiary situations, the court may reserve a portion of that amount for the beneficiary's actual needs for reasonable support, health care, and education (Comment *c*). The beneficiary's rights and authority represent a limited form of ownership equivalence analogous to certain general powers under the rule of §56, Comment *b*; thus the rule of this Comment is

similarly unaffected by a purported spendthrift restraint.

The special rule of §60, Comment *e* also applies to the discretionary right of a beneficiary who is not a trustee but is given power to demand trust distributions pursuant to an expressed or implied standard, whether or not the standard is an objective one (e.g., "support").

The rule does not apply, however, if the discretionary power is held jointly with another person who, in exercising the discretionary authority, has fiduciary duties to other beneficiaries of the trust. Nor does this rule apply on behalf of *transferees* of the beneficiary's interest, although a purchaser who is entitled to restitution based on fraud or mistake, or the like, is a creditor of the beneficiary and may attach the beneficiary's interest for satisfaction of that claim.

5. Self-Settled Trust.

Where the trustee of an irrevocable trust has discretionary authority to pay to the settlor or apply for the settlor's benefit as much of the income or principal as the trustee may determine appropriate, creditors of the settlor can reach the maximum amount the trustee, in the proper exercise of fiduciary discretion, could pay to or apply for the benefit of the settlor. Where the beneficiary is the settlor of only a portion of the trust, the amount the creditor can reach under this rule is limited to that portion of the trust estate.

The special rule of §60, Comment *f* normally does not apply to the settlor-beneficiary's transferees. A purchaser who is entitled to restitution based on fraud or mistake, or the like, however, is a creditor of the beneficiary and may thus attach the settlor-beneficiary's interest for the satisfaction of that claim.

B. Beneficiary Becomes the Trustee.

A common scenario where a court might be inclined to disregard the traditional protection of a spendthrift trust provision is a trust which has a common trustee and beneficiary. This situation commonly occurs when the beneficiary is an heir to the settlor who established a trust for the benefit of various heirs. It is not uncommon for such a testamentary disposition to provide that the beneficiary may become the trustee of his or her own trust at a specified age. Another common and even more disturbing example of a trust with a common trustee and beneficiary is a "marital deduction" trust.

As indicated above, the historical exception to the protections afforded a spendthrift trust is the rule against self-settled trusts which provides that if the settlor is also a beneficiary of the trust, a provision retaining the voluntary or involuntary transfer of his beneficiary interest does not prevent his creditors from satisfying claims from his or her interest in the trust estate.

Historically, the foregoing principals have served to protect the interest of a beneficiary in a trust established by someone other than the beneficiary. An irrevocable trust established by the settlor for the benefit of someone other than the settlor has historically been a bulletproof asset protection strategy.[11] However, in recent years, several cases have allowed a creditor to pierce a spendthrift trust to reach the assets of the trust where the beneficiary had the ability to control distributions to him or herself. Not surprisingly, most of the cases in which a debtor's interest in a spendthrift trust has been pierced have been cases involving a debtor in bankruptcy. In all such cases, it is the ability of the trustee/debtor/beneficiary of the trust to exercise dominion and control over the trust property that is eventually found fatal. Even more disturbing is that some of the trusts involved were "marital deduction" trusts, established by the beneficiary's deceased spouse, to benefit from certain estate tax deductions expressly sanctioned by the Internal Revenue Code to reduce and, in most cases, totally eliminate estate taxes upon the death of the first spouse to die. Examples of cases where spendthrift trusts have been pierced include the following:

1. In Re: McCoy[12].

In McCoy, the debtor in bankruptcy, George R. McCoy, was the sole trustee of the Judith McCoy Family Trust established upon the death of Mrs. McCoy. He was also the beneficiary. The trust was established pursuant to the last will and testament of Mrs. McCoy. Although the will did not give the debtor any express power of appointment or trust assets, nor the express right to revoke or amend the trust, it did give him free discretion to spend all trust assets for any purpose he desired. While the trustee's discretionary power to make distributions included the usual "health, maintenance and support" standards, it also provided that such distributions could be made in such amounts as might be "required or desirable." It is the use of the words "required or desirable," which the court found fatal. The court found that, taken as a whole, the terms of the trust were such that the debtor, in his capacity as trustee, could make payments to himself from the corpus to any extent that he alone determined "desirable." Therefore, the only reasonable interpretation was that the settlor intended the

11 This assumes no fraudulent transfer has occurred.

12 274 BR 751(N.D.) Illinois 2002.

debtor/beneficiary, as sole trustee, to have unfettered dominion and control over the trust. As such, the assets of the trust were includable in the assets of the bankruptcy estate available to pay creditor claims.

2. In the Matter of: Warren and Brenda Bierman[13].

Warren and Brenda Bierman became Chapter 11 bankruptcy debtors on December 16, 1996. The principal issue in the case was whether the assets of The Brenda Bierman Trust were part of the bankruptcy estate. The trust had been established by Mrs. Bierman's mother in 1986. From the inception of the trust to the date following the filing of the bankruptcy case, Brenda Bierman was a beneficiary of the trust and the sole trustee of the trust. She resigned as trustee approximately six months after the commencement of the of the bankruptcy case. One of Mrs. Bierman's daughters and beneficiary of the trust, Tammy Gregerson, was named as successor trustee of the trust. The issue before the court was whether Mrs. Bierman, on the date of her bankruptcy petition, held the power to exercise dominion and control over the trust corpus, thereby negating the "spendthrift clause" of the trust and causing the corpus to become part of the bankruptcy estate.

After reviewing the details of the trust agreement, the court had no problem in concluding that, on the date of the bankruptcy petition, Mrs. Bierman held the power to exercise dominion and control over the trust corpus and, therefore, the trust corpus was property of the bankruptcy estate. The key to the court's finding was the provision governing the distribution of income and principal to Brenda Bierman during her life. The trust agreement provided that:

> *"During the lifetime of Brenda Bierman, the TRUSTEE shall pay or apply the net income and principal of the trust estate as **she** may direct from time to time; but until otherwise directed, the Trustee shall pay the net income to Brenda Bierman at least annually."*

The court found that the above referenced language gave Brenda Bierman the ability to compel the trustee to pay or apply interest and/or principal in any manner Brenda Bierman selected. To make matters worse, the trust agreement further provided, that as trustee, she could encroach upon the principal of the trust to provide for the support, care and comfortable maintenance of Brenda J. Bierman, it being the intent of the trust that she receive sufficient funds to provide the same standard of living as she then maintained, including necessary expense of healthcare. The court thus held that Brenda Bierman, as beneficiary and trustee, had complete control over the trust. She had the ability to direct the trustee, whether it be herself or a subsequent trustee, to pay over the trust income and the entire corpus at any time. She controlled the investing of the trust assets and was able to divest the interest of any or all other beneficiaries by her actions. Since Brenda Bierman had complete control and dominion over the trust corpus, the assets of the trust were not afforded the protection of a spendthrift trust thus resulting in the entire trust corpus becoming property of her bankruptcy estate.

C. Excessive Beneficiary Powers.

Attorneys familiar with the drafting of asset protection trusts will know that a court can force a beneficiary of a trust to exercise any power that the beneficiary may have with respect to that trust. It is therefore extremely important that the beneficiary be given little or no unilateral rights to control any aspect of the trust. To the extent that any such controls are granted, the beneficiary of a spendthrift trust can be forced to exercise those powers in favor of his or her creditors. Failure of a debtor to comply with a court's order to exercise such powers can subject a debtor to a "contempt of court" action.

Regrettably, some estate planning practitioners will sometimes draft a trust that grants significant powers to the beneficiary without taking into account the potential adverse consequences that holding such powers may cause to the beneficiary in the event that the beneficiary of the trust becomes a judgment debtor or, even worse, is involved in bankruptcy proceedings as a debtor in bankruptcy.

Typically, the rights of a debtor in a traditional spendthrift trust are ***not*** property of the debtor's bankruptcy estate. Section 541(c) of the Bankruptcy Code provides that:

> "A restriction on the transfer of a beneficial interest of the debtor in the trust that is enforceable under applicable non-bankruptcy law is enforceable in a case made under this title."

Thus, if the interest of the debtor in a trust is protected under state law, it will likewise be protected in any bankruptcy proceedings. If the interest of the debtor is not protected from creditor claims under applicable state law, it will not be protected in bankruptcy proceedings.

In the New York bankruptcy case of In Re: James M. Herzig[14], the bankruptcy court was required to

13 1998 Bankr. LEXIS 2012.

14 In Re: James M. Herzig, 167 B.R. 707 (1994).

analyze provisions in a testamentary trust, established by the debtor's father, that granted significant powers to his son, a beneficiary of the trust. In the Last Will and Testament of the debtor's father, the decedent appointed his two sons, William and James, as executors and trustees under his Will. James renounced his appointment as an executor and trustee of the Will less than two months after his father's death. As a result, his brother William acted as the sole executor of the Will and sole trustee of the testamentary trust provided in their father's Will.

Among the powers that were granted to the trustees of the testamentary trust were:

- Any trustee could at any time resign and designate a successor trustee by written instrument.
- In the event William Herzig, the debtor's brother, should ever be unable or unwilling to serve as trustee, any attempt to appoint a successor trustee to William would not be valid unless it was approved by the debtor, James Herzig. If James Herzig did not approve of the appointment of the successor trustee, the trust would terminate and the assets remaining in the trust would be distributed to James Herzig unless his wife Margaret was willing to qualify and act as successor trustee.
- James Herzig had the right, at any time, to require his brother William, to resign as trustee in which event, he would be succeeded as trustee by the debtor's wife, Margaret, but only if she was then living with James.

In analyzing the case, the bankruptcy court admitted that the debtor would not be deemed to have any control over the assets of the trust so long as his brother William remained as the sole trustee. However, the debtor was given the express power to require his brother William to resign. William would have the right to appoint his successor but only if such successor was approved by the debtor, James. If not, the trust would terminate and assets distributed to James unless his wife Margaret was willing and qualified to become trustee. However, to qualify as a successor trustee, she was required to "be living with debtor" at the time of her qualification as trustee.

Although the debtor and his wife Margaret were living together at the time, the court noted that the debtor could, theoretically, take up residence elsewhere, and require his brother William to resign and refuse to agree to the appointment of a successor to William, thus obtaining the trust assets. As the Court noted:

> "Termination of this Trust does not require drastic action on Debtor's part. He can, under the scenario outlined above, and with minimal inconvenience to himself, cause the corpus of the Trust to be distributed to him. Debtor could move back home and resume his normal life, since the will language does not require either a separation of a specific duration or an intent to remain apart for the indefinite future. This possibility destroys the spendthrift aspect of the Trust and Debtor's interest becomes property of his estate. The issue is not, as Debtor would have it, the ability of a bankruptcy trustee to exercise the options available to Debtor. It is that the mere existence of the power described causes the spendthrift provision to fail. This is true as to both the statutory and common law elements."[15]

D. Retained Interest in Tax Motivated Trust.

Estate planners are suddenly realizing that the mere fact that a trust or similar structure has been expressly sanctioned by the Internal Revenue Service does not necessarily prevent it from surviving a creditor attack based upon well recognized concepts under common law or state law, particularly the general prohibition against protecting a settlor's interest in a "self-settled trust." Such retained interests are common in a Grantor Retained Annuity Trust ("GRAT"), a Qualified Personal Residence Trust ("QPRT"), Charitable Lead Trust and Charitable Remainder Trust ("CLUT," "CLAT," "CRUT," and "CRAT").

The common law prohibition against protecting the interest of a settlor in a self-settled trust became painfully evident in the recent bankruptcy case of In Re Mack[16] which involved a Charitable Remainder Unitrust (the "CRUT"). In the Mack case, the debtor has established a Charitable Remainder Unitrust wherein he named himself as the income beneficiary of the CRUT for his life. Because of the nature of a CRUT, the income interest which the settlor retained in the CRUT was a self-settled interest. As a result, when the matter came before the U. S. Bankruptcy Court for the District of Minnesota, Judge Nancy Dreher identified the issue as whether the facts of the case required the Court to determine whether the debtor's interest in the CRUT, as well as his rights as income beneficiary to remove and replace trustees and to

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15 In Re: James M. Herzig, 167 B.R. 707, 711 (1994)

16 In Re Mack, 269 B.R. 392 (2001)

amend the trust to protect its tax benefit status, were property of the estate. Many of the issues which had originally also been raised by the bankruptcy trustee were eventually dropped. Therefore, the only remaining issues upon trial were to determine (a) whether the bankruptcy trustee was entitled to the income from the trust which, by the terms of the CRUT, were to be distributed to the debtor annually over his life and (b) whether the trustee could step into the settlor's shoes as income beneficiary and thereby control who managed the trust assets.

In reading the opinion, the reader gets a hint at the direction that Judge Dreher was heading when she posed one of the issues in front of her as whether or not Congress and the state of Minnesota "in passing CRUT-governing statutes, intended not only to encourage charitable giving by allowing tax avoidance or deferral, but also to create a new protection from creditors to those wealthy enough to give away the remainder interest in assets. In other words, do we have a new bankruptcy planning tool for the wealthy?"[17]

After noting that Federal Courts have consistently concluded that Minnesota courts would not recognize a spendthrift trust where the trust was self-settled, Judge Dreher went on to also note that the rule that a settlor cannot protect his interest in a CRUT through a spendthrift provision was also clear in the common law:

> "(1) Where a person created for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interests, (2) Where a person created for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit."[18]

After an exhausting examination of the history of both common law, state law, and Congressional intentions regarding tax favored structures such as a Charitable Remainder Unitrust, the court nevertheless determined that the income interest of the debtor in bankruptcy and settlor of the trust, Jeffrey C. Mack, was property of the bankruptcy estate, together with a power to appoint or discharge trustees of the trust and power to amend the trust to preserve its tax qualified status. Thus, the court ordered the trustees of the CRUT, together with any successor trustees, to recognize the bankruptcy estate as a holder of the lifetime income interest and powers held by the settlor of the trust, Mr. Mack, and to pay future distributions payable to Mr. Mack pursuant to the CRUT to the bankruptcy trustee.

E. Divorce Setting.

In a divorce setting in a community property state such as Texas, the problem of dominion and control can also lead to piercing of a trust. Some Texas courts have held that trust income, accumulated in a Texas trust, may be subject to division upon divorce in those situations where the beneficiary was entitled to withdraw the income but instead elected to allow the trust to retain it. This issue can be problematic in a situation where the beneficiary of the trust is also the trustee. In a divorce setting in a community property state such as Texas, the spouse can allege that the trustee elected not to distribute income from the trust in order to avoid having it become part of the community property estate divisible upon divorce. If the beneficiary, in his or her capacity as trustee, had the power to distribute the income for his own benefit, but elected not to, there is sufficient case authority for the proposition that such is community property subject to division upon divorce. A similar result will result if the beneficiary has the right to receive income but elects to leave it in the trust. An excellent example of a case where that occurred is a 1977 Texas divorce case where the beneficiary husband the beneficiary husband had an absolute right to receive the income from the trust but had elected to allow the income, which he had the right to receive, to remain within the trust. In those cases, accumulated income in the trust, to the extent that it is under the "control" of the beneficiary, will likely be treated as community or marital property and, therefore, subject to division upon divorce.[19]

F. Levy on Trust Distributions and Liability of Trustee for Indirect Distributions to Beneficiary.

In a Chief Counsel Advice Memoranda issued on November 30, 2005, the Internal Revenue Service reiterated the rule that it may levy a taxpayer's fixed right to trust income and the taxpayer's fixed right to obtain a future distribution from corpus. However, and even more relevant, the Internal Revenue Service restated its position that when a trustee distributes funds that the trustee knows are encumbered by a federal tax lien, the trustee is personally liable for

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17 In Re Mack, supra, at 17.

18 In Re Mack, supra, at 22.

19 In the Matter of the Marriage of Long, 542 S.W.2d, 712, 718 (Tex. Civ. App. – Texarkana, 1976, no writ).

tortious conversion, specifically, intentionally impairing the rights of the Internal Revenue Service.[20]

Spendthrift provisions, which are self-created exemptions, cannot defeat a federal tax lien. In Leuschner v. First Western Bank & Trust, the Ninth Circuit affirmed that a taxpayer's interest in a trust could be reached by the federal tax lien, observing that "there is no doubt that the paramount right to collect taxes of the federal government overrides a state's statute providing for exemptions."[21] Thus, the spendthrift provision of a trust, however effective against certain creditors' claims, is ineffective at insulating assets of the trust from levy by the IRS, provided that such assets are first found to constitute the "property" or "right to property" of the taxpayer.

In the facts of CCA 2006 14006, the taxpayer was, apparently, both the beneficiary and trustee of a trust established by a then-deceased family member. The trust provided that the taxpayer was entitled to receive, at a minimum, all current income of the trust. The distribution of current income to the beneficiary was mandatory and not subject to the exercise of discretion on the part of the trustee. As a result, such mandatory distribution of current income was a property right of the taxpayer that could be levied by the IRS and collected as payable. Pursuant to Revenue Rule 55-210, an IRS levy could seize the entire stream of income payments, namely, the income payments currently due in all future income payments to the indebted beneficiary.

Although most of the specific facts of IRS CCA 2006 14006 were redacted before publication, the trustee of the trust, who was apparently also the beneficiary, apparently attempted to make indirect payments for his benefit once his regular distributions were levied by the IRS. In the Chief Counsel's Advice, the government offered, as an alternative or supplement to a suit to enforce a levy, the right of the federal government to sue the holder of the taxpayer's property for tortious conversion of the federal tax lien. Thus, as an alternative to the levy, the federal government could also sue the trustee-taxpayer if he or she intentionally made distributions of funds encumbered with a federal tax lien and, as a result, the funds disappear into the stream of commerce.

G. Annuities & Life Insurance – Case Law Exceptions To State Exemption Statutes.

Employment-related retirement plans in the United States generally enjoy good protection from creditor claims either under Federal law or under most state laws. Any employment-related retirement plan that is covered under the U.S. Employment Retirement Income Security Act ("ERISA") provides strong "anti-alienation" provisions to protect those plans against the claims of creditors of plan participants. However, employment-related retirement plans that do not qualify for Federal law protection are typically protected by state law in most states. However, the foregoing protections apply only to employment related retirement and similar plans, whether in the form of annuities or otherwise. Only a handful of states provide protection for annuities and life insurance policies that are purchased by an individual to supplement their income upon retirement or provide for their families upon their premature death.

1. Protection of Annuities Under State Law.

As of the writing of this paper, only ten states provide for unlimited protection of annuities and the proceeds from those annuities against the creditor claims of the annuity owner.[22] A total of 16 states, including Colorado, Connecticut, Iowa, Massachusetts, Rhode Island, and Virginia, provide for no protection whatsoever against creditor claims against an annuity or annuity payments received by an annuitant. Of the remaining states, the bulk of the remaining states provide for limited protection for annuity payments or policy proceeds. In some cases, the amount of annuity payment that is protected from creditor claims is a very small amount, typically varying from $350 to $500 per month; although, states like Pennsylvania limit to $100 the amount of the monthly annuity payments that are exempt from creditor claims. In other states, annuity payments of a limited amount enjoy similar protections but only if such payments are being made to the dependents of the annuity owner, such as a dependent's spouse and children. As discussed below, that is similar to the protection afforded annuities in Switzerland, but without any limitation on the amount of the benefits protected from a creditor's claim.

2. Life Insurance Protection Under State Law.

Like their annuity counterparts, life insurance policies are fully protected in the hands of their owners

20 IRS CCA 2006 14006

21 Leuschner v. First Western Bank & Trust, 261 F.2d 705, 708 (9th Cir. 1958).

22 Arizona—Ariz. Rev. Stat. §33-1126A7; Florida—Fla. Stat. Ann. §22.14; Hawaii—Hawaii Rev. Stat §431-10-232; Kansas—Kan. Stat. Ann. §§60-2313(a)(7), 40-414; Louisiana—La. Rev. Stat Ann. §22-647(B); Maryland—Md. Code Ann. Ins. §16-111(a); Michigan—Mich. Comp. Laws Ann. §500-2207; New Mexico—N.M. Stat. Ann. §42-10-3; Oklahoma—36 Okla. St. Ann. §3631.1; Texas—Tex. Ins. Code §1108.051

in only ten states. Likewise, many states provide limited or no protection whatsoever to the owner of a life insurance policy. However, unlike annuities, many states do provide that the proceeds of a life insurance policy, meaning that the insured individual has died, are fully protected from creditor claims if such proceeds are paid to, typically, family members and other dependents of the insured. However, even in most of those states, should the owner of the policy be subject to creditor claims that are reduced to judgment prior to the death of the policy owner, a judgment creditor could seize the policy while the owner-insured is still alive and, in most cases, redeem the policy for its cash surrender value. In any event, if the intention of the owner-insured was to own a policy to provide for his dependents upon his death, irrespective of potential financial misfortunes, the ability to achieve that goal cannot be realized in the majority of states if the owner-insured owns that policy when claims against him or her are reduced to judgment.

3. Judicial Exceptions to State Exemption Statutes.

Despite the fact that some states have provided generous and sometimes unlimited protection for annuities and life insurance policies, a definite trend has developed in some states that has resulted in courts adopting judiciary mandated exceptions to otherwise favorable state exemption laws. In other words, despite the protections provided by some state laws for annuities and life insurance policies, some courts have unilaterally decided that such protections should be not be available in all cases, notwithstanding the clear language of state law providing for such unlimited protection.

In most cases where courts have ignored the unlimited exemption available under state law, the courts have found that the annuity or life insurance policy that the debtor sought to protect had characteristics that made the policies look more like sophisticated investment products rather than traditional annuities or life insurance policies that were intended to provide a reasonable basis of support during retirement or provide adequate life insurance proceeds for the individual's family upon his death.

In the case of Dona Anna Savings & Loan Association, F.A. vs. Dofflemeyer,[23] the language of the New Mexico exemption statute at that time provided that "any interest in or proceeds from a pension or retirement fund of every person supporting only himself is exempt from . . . attachment, execution or foreclosure by a judgment creditor."[24] At that time, New Mexico law clearly provided for the unlimited protection of annuities and life insurance policies. In its analysis, the court took note of the accepted use and definition of an annuity when the exemption statute was first adopted in 1887 by the New Mexico legislature. The court reasoned that, in 1887, the exemption was ostensibly adopted to provide an exemption statute to "protect families from becoming destitute as a result of misfortunate through common debts which are generally unforeseen."[25] In the time period of over 100 years since the exemption statute had been adopted, the Legislature had never attempted to change the definition or the amount that is protected from creditor claims of the owner of the annuity. In fact, some annuities had essentially become sophisticated agreements that, in many cases, provided significant tax deferral to high net worth individuals. Thus, pursuant to the court's analysis, a high net worth individual purchasing a $5 million annuity in a state such as Texas, where annuities are fully exempt from creditor claims, could, using the New Mexico court's rationale, find that a $5 million annuity was far in excess of what the Legislature had in mind when it first adopted the unlimited exemption for annuities for the purpose of protecting an individual's retirement savings thus enabling him to provide for his family upon his disability or retirement. In any event, the New Mexico court held that, despite the state's unlimited exemption of annuities, the annuity would not be entitled to the exemptions against creditor claims available under state law if the annuity was nothing more than a tax advantaged investment contract even though it was technically an annuity.

A similar situation occurred in the bankruptcy case of In re Payne[26] this time involving life insurance. The bankruptcy proceedings were commenced in the state of California where a debtor attempted to claim an exemption of his annuity under state law while the bankruptcy trustee argued that the annuity was merely an investment vehicle and therefore did not qualify as an annuity or life insurance under relevant California exemption laws. At the time, California law provided that an annuity would be exempt from creditor claims only if it is qualified as a life insurance policy. After reviewing the history of the exemptions available under California law for annuities and life insurance, the court ruled that where the annuity contains some attributes of insurance and some of investment, the

23 Dona Anna Savings & Loan Association, F.A. vs. Dofflemeyer,115 N.M. 590, 855 P.2d 1054 (1993)

24 (N.M. Stat. Ann. 42-10-2 (Cumm. Supp. 1993)

25 Thomson vs. Lerner, 25 T.2d 209, 210-11

26 In re Payne, 323 B.R. 723, (9th Cir. 2005)

analysis must include a determination of the primary purpose of the annuity. If the primary purpose of the annuity was investment, then the annuity would not qualify as life insurance for purposes of the exemption statute. After reviewing the facts, the Ninth Circuit Court of Appeals held that the annuity contract was primarily an investment contract and, therefore, not entitled to exemption and protection from claims of creditors under California law.[27]

4. The Concern Over Continued Erosion of Existing U.S. Protections.

While very few court have addressed this issue in the United States, many professional advisors are concerned with the increasing trend by courts to unilaterally reclassify as an "investment contract", a policy, issued by an insurance company, that is structured either as an annuity or a life insurance policy.

Likewise, it is not difficult to see that insurance products, particularly annuities, that may enjoy protection from creditor claims by statutes in a handful of states adopted over 100 years ago, bear little resemblance to tax advantaged annuities and complex variable life insurance products that are now available in today's market. Thus, while annuities purchased by Americans from their earnings with the primary goal of supplementing their retirement income will likely continue to enjoy applicable state protections, if any, modern annuity and life insurance products offered to high net worth individuals are likely to run the risk that, in the event of creditor attack, a court may find that the contract is nothing more than an investment contract rather than a traditional annuity or life insurance policy entitled to whatever exemption or protections that might be available under state law. Nevertheless, as will be discussed below, this problem can possibly be avoided for annuities and life insurance, when integrated into an estate planning or similar wealth preservation structure as such are now available in 13 states of the United States, including the state of Delaware.

H. Piercing the Irrevocable Life Insurance Trust ("ILIT").

A typical irrevocable life insurance trust will have nominal value during most of the life of the insured. Contributions are usually used to pay premiums on the life insurance policy held by the ILIT. As the age of the insured increases, the value of the life insurance policy owned by the ILIT also increases. However, upon the death of the insured, the value of the ILIT will grow substantially. When that happens, the assets of the ILIT could be seen by a creditor of a trust beneficiary as a potential source of recovery for claims against such beneficiary. However, in a recent California case where an attempt was made to pierce an ILIT to reach the assets of the trust, the creditor was actually a creditor of the insured who established the trust.

In the 2006 California case of Laycock v. Hammer, the settlor and insured, Spearl Ellison, created an irrevocable life insurance trust wherein Ellison, as settlor, specifically declared that the trust was irrevocable, and that after the execution of the trust, the settlor would have no right, title, or interest in, or power, privilege, or incident of ownership in regards to any of the property of the trust and no right to alter, amend, revoke or terminate the trust or any of the provisions.

Shortly after establishing the trust, on September 29, 1989, Ellison assigned to the trust all of his "rights, titles, interest, and incidents of ownership" in a policy issued by Southwestern Life Insurance Company. On October 13, 1989, the trustee of the trust was designated as the beneficiary of the policy.

In 1992, the Resolution Trust Corporation ("RTC"), as successor to a failed savings & loan association, obtained a judgment against Spearl Ellison and his wife totaling $735,000.00. The judgment grew out of the default by the Mr. and Mrs. Ellison on two promissory notes secured by mortgages on commercial property in Kansas. The judgments were later acquired by Leonard Hammer, the current claimant.

On April 23, 2003, Mr. Ellison died. Linda Laycock, in addition to the role as trustee of the ILIT, served as trustee of the family trust. Hammer then sought to attempt to reach the assets of the life insurance trust. As trustee of the ILIT, Ms. Laycock filed a petition for a determination that the insurance trust was exempt from Hammer's claims. In response to the motion, Hammer produced evidence which allegedly supported the following factual findings:

- Ellison acted as a co-trustee of the trust
- Funds from the trust were distributed to his great grandchildren
- He communicated about the insurance policy with his insurance agent and insurance company
- Ellison borrowed funds from the policy
- Laycock used funds from the family trust to repay the amounts Ellison borrowed from the insurance policy because she believed the loan were Ellison's debts
- Other trust beneficiaries advised Ms. Laycock that they believed Ellison should be permitted to do as he pleased with money he earned in his lifetime

Notwithstanding the foregoing, the trial court ruled in favor of Ms. Laycock's motion for summary judgment. The trial court found that under prevailing California law, all the acts Hammer relied upon would not have converted the trust from an irrevocable trust to a revocable trust. The court found that California law did not recognize any doctrine of implied revocation of an irrevocable trust and, in any event, the evidence Hammer presented did not raise any material inference that Ellison had control or ownership of the trust.

On appeal, the California Court of Appeals evaluated California law and determined that, contrary to Hammer's argument, a settlor's conduct after an irrevocable trust had been established will not alter the nature of such a trust. Interestingly, the Court of Appeals relied, in part, on Federal estate tax cases that, after applying a broader incidence of ownership test, had found that breaches of the terms of a trust by a trust settlor will not make a settlor the owner of trust property for purposes of applying the federal estate tax.

In the view of the Court of Appeals, the terms of the Ellison ILIT, as well as the terms by which he transferred the policy to the trust, were unambiguous. The trust was irrevocable and the transfer of the policy was similarly irrevocable. Thus the policy proceeds were the property of the trust and not a part of Ellison's estate. More importantly, the court did not agree with Hammer's interpretation of the facts that Hammer alleged evidenced ownership of the trust by Ellison. The only document that was found that could potentially raise an inference of control or ownership over the trust was documents which listed Mr. Ellison as a co-trustee of the insurance policy account. However, the Court of Appeals held that, even if they were to accept as truth the fact that the insurance company treated Mr. Ellison as a co-trustee, this in itself would not help the creditors' cause because there was no law prohibiting settlors of a trust from being trustees or co-trustees of an irrevocable trust. Thus, transfers to the life insurance trust were irrevocable and, consequently, the assets of the trust were not available to the creditors of Mr. Ellison, the settlor of the trust, upon his death.

Since the trust was established as an ILIT for estate planning purposes, Mr. Ellison obviously could not exercise incidents of ownership over the policy without jeopardizing the intended tax benefits of the trust. More importantly, the court's decision is clearly based upon its conclusion that the acts of Mr. Ellison were not sufficient to evidence dominion and control over the assets of the trust.

What this author finds is the most interesting aspect of this case is the court's reliance, by analogy, to federal estate tax cases which, applying a broader "incidence of ownership test", have found that breaches of the terms of a trust by a settlor will not make the settlor the owner of trust property for purposes of applying the federal estate tax. This is based upon the premise that incidence of ownership denotes the legal power to exercise ownership, not a decedent's practical ability to do so.

Notwithstanding the decision in Laycock, settlors of a life insurance trust should always strive to avoid any indication of dominion and control over the trust to avoid any attempts to pierce the trust after the decedent's death, particularly in those cases where the alleged dominion and control would jeopardize the tax benefits for which the ILIT was designed. If the trust is found to be a sham, the assets of the trust could also be at risk from the claims of creditors of a trust beneficiary. After all, as with any legal entity, a court is less likely to respect a trust as a separate and distinct legal structure if the settlor or trustee of the trust do not treat the trust with the same deference that is expected from a settlor in an arms length transaction and, more importantly, a trustee with fiduciary duties to the trust and the beneficiaries of the trust.

I. Fraudulent Transfer Issues.

The wealth preservation planning strategies referenced in this paper assume that the attorney and client are both satisfied their activities do not involve any attempts to hinder, delay, or defraud any existing creditor of the debtor. However, if the client has been less than honest to the attorney, or if the attorney has totally failed to dissuade the client from engaging in fraudulent transfers, a multitude of tools are available to both a creditor and a bankruptcy trustee, to set aside an alleged fraudulent transfer conveyance. The bankruptcy and fraudulent conveyance remedies available to creditors and bankruptcy trustees all have strict statute of limitation restrictions that are applicable under U.S. law. In the event that the conveyances have been made to an offshore entity, it will be necessary to look at the applicable fraudulent conveyance provisions of that jurisdiction to determine whether it will be possible to enforce a fraudulent conveyance action in the United States against an individual or entity located in a foreign jurisdiction, particularly when the U.S. court does not have personal jurisdiction over the foreign entity.

1. Uniform Fraudulent Transfer Act.

All but a handful of states have adopted the Uniform Fraudulent Transfer Act.[28] In reviewing the

28 Those states that have not adopted the Uniform Fraudulent Transfer Act follow the old Uniform Fraudulent Conveyance Act originally adopted in 1918.

provisions of the Act, it is important to note that relief under the act may be sought by either a creditor or a trustee in bankruptcy. More importantly, different types of creditors have different standing to bring an action under the act. The statute of limitation applicable to transfers also varies depending on the nature of the transfer.

a. Transfer Fraudulent as to Present and Future Creditors.

The Act provides that a transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or within a reasonable time after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

i. with actual intent to hinder, delay, or defraud any creditor of the debtor; or
ii. without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

- was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
- intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.

In determining actual intent under the Act, consideration may be given, among other factors, to whether:

- the transfer or obligation was to an insider;
- the debtor retained possession or control of the property transferred after the transfer;
- the transfer or obligation was concealed;
- before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
- the transfer was of substantially all the debtor's assets;
- the debtor absconded;
- the debtor removed or concealed assets;
- the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
- the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
- the transfer occurred shortly before or shortly after a substantial debt was incurred; and
- the debtor transferred the essential assets of the business to a lien or who transferred the assets to an insider of the debtor.

b. Statutory Remedies of Creditors.

Assuming a fraudulent conveyance has occurred, the Act provides that an aggrieved creditor may obtain:

i. avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim;
ii. an attachment or other provisional remedy against the asset transferred or other property of the transferee in accordance with the applicable Texas Rules of Civil Procedure and the Civil Practice and Remedies Code relating to ancillary proceedings; or
iii. subject to applicable principles of equity and in accordance with applicable rules of civil procedure;

- an injunction against further disposition by the debtor or a transferee, or both, of the asset transferred or of other property;
- appointment of a receiver to take charge of the asset transferred or of other property of the transferee; or
- any other relief the circumstances may require.

iv. If a creditor has obtained a judgment on a claim against the debtor, the creditor, if the court so orders, may levy execution on the asset transferred or its proceeds.

2. Bankruptcy Fraudulent Transfer Provisions.

Section 548 of the United States Bankruptcy Code provides that the trustee may set aside any transfer of an interest of the debtor and property, or any obligation incurred by the debtor, that was made or incurred on or within two years before the date of the filing of the Petition (assuming the case is commenced after October 17, 2005), if the debtor voluntarily or involuntarily—

a. made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such

transfer was made or such obligation was incurred, indebted; or

b. [1] received less than a reasonably equivalent value in exchange for such transfer or obligation; and

[2] (a) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
(b) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
(c) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

Section 548(b) provides that the trustee of a partnership debtor may avoid any transfer of an interest of the debtor and property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the Petition, to a general partner in the debtor, if the debtor was insolvent on the date such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation.

If a transfer is made or obligation incurred more than two years prior to bankruptcy, the trustee must rely upon his/her rights under the fraudulent conveyance statutes of the debtor's home state. The trustee is entitled to rely on such state provisions under §544(b) of the U.S. Bankruptcy Code. This is particularly helpful to a U.S. Bankruptcy Trustee since most fraudulent transfer state statutes provide for a four-year statute of limitation period, rather than the two-year period provided by bankruptcy law.

3. Estate Tax Motivations vs. Intent to Defraud Creditors.

As discussed in Article 2 above regarding the provisions of the Bankruptcy Reform Act of 2005, the bankruptcy trustee has gained an incredibly powerful tool in new section 548(e)(1)(A) of the Bankruptcy Code which allows the trustee up to ten (10) years to target a transfer made to "a self-settled trust or similar device" although no definition of a self-settled device is provided. Fortunately, the provisions of the newly enacted legislation require that the trustee must prove that such transfers were made "with actual intent to hinder, delay, or defraud" a creditor. Inclusion of the words "actual intent" is a much higher standard to prove in attempting to prove that a transfer to a "self-settled trust or similar device" was made to "hinder, delay, or defraud" a creditor. However, and more importantly, estate planners must now be aware of the fact that transfers into estate planning structures, especially in light of the ambiguity regarding the definition of a "**self-settled trust or similar device**" may result in owners or beneficiaries of the structures being subject to attack by a bankruptcy trustee long after the drafting lawyer has discarded his files and most documentation regarding the original transaction has been lost or discarded. In this author's view, in light of the ambiguities of what is covered by the new "ten-year look back" rule, it is prudent that estate tax practitioners document the solvency and reasons behind a transfer at the time that it is actually consummated, much the same way as a debtor's solvency is documented at the time that he or she establishes a foreign trust. In this way, should a bankruptcy trustee decide to challenge a transfer nine years later, after the drafting lawyer has discarded his file in the normal course of business, the beneficiaries of the structure should have in their files contemporaneously prepared documents that enable them to prove that the original transfer into the estate tax structure that is now under bankruptcy court scrutiny was done at a time when the settlor or transferor was fully solvent and not done with the purpose of delaying or hindering his or her creditors.

While recent court cases have criticized entities that have been formed merely for tax reasons, there are times when proving the tax motivation behind forming an entity will actually be crucial in a court's decision to respect the structure. Of course, this requires the drafting attorney to consider multiple issues that might arise in connection with the formation of the entity and the financial solvency of the parties involved.

a. In Re: Earle.

An excellent example of where tax motivations were successful in defeating an allegation that a transfer was a fraudulent one was the somewhat recent case of In Re: Thomas J. Earle, Jr. et al., 307 B.R. 276 (2002). In the Earle case, the debtors in bankruptcy filed a petition for relief under Chapter 13 of the U.S. Bankruptcy Code which one of the debtor's creditors attempted to convert to a Chapter 7 bankruptcy proceeding on the basis that the debtor's transfer of certain real estate into a trust was a fraudulent transfer done "with actual intent to hinder, delay, or defraud creditors" in violation of Alabama's fraudulent transfer statute. Ala. Code §8-9 A-4(a).

Mr. and Mrs. Earle had initially filed a Chapter 13 case on November 26, 2001. The Earles had lived in a home located in Stockton, Alabama since the 1970s. The home was lost pursuant to a tax sale in June 1994.

However, Mrs. Earle successfully redeemed the property from the purchaser in December 1997.

On June 26, 1998, Mrs. Earle formed a Qualified Personal Residence Trust ("QPRT") as provided for in Internal Revenue Code §2702. She transferred the entire home into the QPRT which granted her a life estate and the exclusive right to live in the home, rent free, up until the earlier of her death or the expiration of 20 years.

At the time that the Earle QPRT was created, the Stockton property was her primary asset. No other significant assets existed. As a result, when Mr. and Mrs. Earle sought bankruptcy protection less than four years later, a creditor filed an adversary proceeding to set aside the transfer of the residence to the QPRT as a fraudulent transfer under Alabama law.

Although Mr. and Mrs. Earle had experienced multiple financial difficulties, it is the testimony of the professionals who arranged for the transfer that was crucial to the ultimate outcome of the case. Specifically, although the court did an exhaustive analysis of the application of the various "badges of fraud" to the facts of this case, what was extremely significant to the court in its decision was the fact that Mrs. Earle had been speaking to a local accountant, well before the transfer, in connection with her own mother-in-law's estate which had incurred significant estate taxes. The accountant was the accountant for Mrs. Earle's mother-in-law's estate. The estate tax return for the debtor's mother-in-law was due in January 1998, a few months before the Earle QPRT was formed. The attorney of the estate testified that significant concerns existed in January, 1998, regarding the estate tax liability that was going to be generated by the filing of the estate tax return and the lack of liquidity from which to pay those estate taxes. During those discussions, in an effort to avoid a similar fate for the debtor, the same attorney for the estate suggested to the debtor that she seriously consider the estate tax benefits of a Qualified Personal Residence Trust in order to reduce her potential estate tax liability. It was extremely important to the court to note that it was the attorney's suggestion, not that of the debtor, that Mrs. Earle form a QPRT trust, although the idea of a QPRT trust had also been "planted" in the debtor's head by the accountant for the estate.

In the court's view, this was a very significant fact. It showed that the Earle QPRT was not created in a vacuum; the debtor, Mary Earle and her accountant, had seen her mother-in-law incur estate tax liability that caused problems for the entire family. The idea of a QPRT was not the idea of the debtor but that of the accountant, presumably in an effort to keep the debtor Mary Earle from experiencing problems similar to those experienced by her mother-in-law's estate. The fact that the debtor's accountant, and not the debtor herself, had arrived at the idea of forming a QPRT was another strong indication that the debtor, Mary Earle, did not actually intend to defraud creditors in conveying her Stockton home to the QPRT (citing In Re: Mark, 88 B.R. 436, 438-39) Bankr. S.D. Fla. 1988) in which the court held that no fraudulent intent was found where a trust and annuity were proposed by an estate planning attorney unrelated to the debtor and the trust and annuity were designed solely for estate planning purposes to minimize estate taxes.

All of the foregoing estate tax reasons for forming the QPRT at the time that they did helped to overcome the allegation that the home was transferred into the QPRT primarily for the purpose of delaying, hindering, and defrauding the creditors of the bankrupt debtor. The court therefore held that the creditor had failed to prove that the real property was transferred to the trust "with actual intent to hinder, delay, or defraud creditors."

VII. STATUTORY EXCEPTIONS TO SPENDTHRIFT TRUST PROTECTION AND ATTEMPTS TO CREATE EXCEPTIONS FOR INTENTIONAL TORTS.

The issue of the ability of an individual to protect the assets in a spendthrift trust has recently been heavily debated as a result of the trend of individual states to allow for "self-settled" asset protection trusts. In fact, the issue of the ability to use such "self-settled" trust to protect the assets of a settlor-beneficiary was hotly debated in 2005 by the U.S. Senate when debating what ultimately became the Bankruptcy Abuse Prevention and Consumer Act of 2005. Despite the many ethical and moral issues involved, attempts to limit the use of "self-settled" trusts, particularly asset protection trusts, failed in the U.S. Congress. In fact, since the trend first began in 1987, approximately 13 states have adopted legislation designed to protect the interest of a settlor-beneficiary in a "self-settled" trust.

Part of the debate over the ethicacy of such trusts goes to the issue of whether such trust should provide any type of protection to an individual who has caused serious personal injury or financial harm, whether or not the trust is self-settled. In fact, during the debates surrounding the Restatement of Trusts, 3d as well as the Uniform Trust Code, the issue of the extent to which exceptions would be made to the general spendthrift trust protection rule was heavily debated. In fact, some individuals are claiming that such protections violate public policy in, at least, egregious situations.

A. Restatement and Uniform Trust Code.

Both the Restatement of Trusts, 3d as well as the new Uniform Trust Code provide certain exceptions for particular types of claims which are allowed to reach the beneficial interest in a spendthrift trust notwithstanding a well-drafted spendthrift trust provision. The general rule is best illustrated by Section 503 of the Uniform Trust Code which provides that:

(a) In this section, "child" includes any person for whom an order or judgment for child support has been entered in this or another State.
(b) Even if a trust contains a spendthrift provision, a beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance, or a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust, may obtain from a court an order attaching present or future distributions to or for the benefit of the beneficiary.
(c) A spendthrift provision is unenforceable against a claim of this state or the United States to the extent a statute of this State or federal law so provides.

The exception in subsection (b) for judgments or orders to support a beneficiary's child or current or former spouse is in accord with Restatement (Third) of Trusts § 59(a) and numerous state statutes. It is also consistent with federal bankruptcy law, which exempts such support orders from discharge. The effect of this exception is to permit the claimant for unpaid support to attach present or future distributions that would otherwise be made to the beneficiary. Distributions subject to attachment include distributions required by the express terms of the trust, such as mandatory payments of income, and distributions the trustee has otherwise decided to make, such as through the exercise of discretion. Subsection (b), unlike Section 504 of the UTC, does not authorize the spousal or child claimant to compel a distribution from the trust. Section 504 authorizes a spouse or child claimant to compel a distribution to the extent the trustee has abused a discretion or failed to comply with a standard for distribution.

Subsection (b) refers both to "support" and "maintenance" in order to accommodate differences among the States in terminology employed. No difference in meaning between the two terms is intended.

The definition of "child" in subsection (a) accommodates the differing approaches states take to defining the class of individuals eligible for child support, including such issues as whether support can be awarded to stepchildren. However the state making the award chooses to define "child" will be recognized under this Code, whether the order sought to be enforced was entered in the same or different State.

Interestingly, the Uniform Trust Code provides an express exception for the superior claims of a state or the United States to the extent that a statute of the state or federal law otherwise provides. This contrasts with the approach taken in Section 59 of the Restatement of Trusts, 3d, which does not specifically address the statutory claims of states or the federal government. Instead, the comments to the Restatement simply provide that implicit in the rule of Section 59 of the Restatement, as a statement of common law, is that government claimants, and other claimants as well, may reach the interest of a beneficiary of a spendthrift trust to the extent provided by federal law or an applicable state statute. An obvious example of such an exception would be the Supremacy Clause found in the U.S. Constitution. In any event, the Uniform Trust Code expressly makes an exception for claims of a state or the United States but only to the extent that the operative statute in question grants the governmental authority the ability to reach the interest of the beneficiary in the trust.

B. Debate Over Exceptions for Tort and Other Claims.

The Reporter's Notes to Section 59 of the Restatement of Trusts, Third, indicates that the basic rationale for the protections found in a spendthrift trust provision is based on the premise that freedom of disposition in this country allows a property owner to impose conditions and limitations on beneficial interests he or she creates in a trust, but only to the extent they are not illegal or contrary to public policy. Thus, the Restatement provides for the exceptions found in Section 59 and expanded upon in Section 503 of the Uniform Trust Code. While this author has not undertaken a state-by-state examination of the extent to which the exceptions provided by Section 59 of the Restatement or Section 503 of the Uniform Trust Code have been followed, as a general rule, it does appear that many states, including some that have not adopted the Uniform Trust Code, have nevertheless adopted the exception for child support payments. However, the claims of former spouses do not seem to have been generally incorporated into most state laws.

Notwithstanding the exceptions articulated in the Restatement and Section 503 of the Uniform Trust Code, an exception which is not found in either the

Restatement or the UTC is an exception for tort claims. However, that has not prevented some claimants from attempting to create a common law exception for tort claims.

Possibly one of the first attempts to carve an exception to the general rule was found in the Mississippi case of Sligh v. First Nat'l Bank, 704 So. 2d 1020 (Miss. 1997). In Sligh, William B. Sligh was involved in an auto accident with Gene Lorance, an uninsured motorist who was operating a vehicle while intoxicated. As a result of the accident, Mr. Sligh suffered a broken spine and resulting paralysis, including loss of the use of both legs, loss of all sexual functions, and loss of the ability to control bowel and urinary functions. Lorance was convicted of the felony of driving under the influence and causing bodily injury to another, for which he was sentenced to serve ten years in prison, with six years suspended.

Shortly after the accident, Mr. Sligh and his wife filed a lawsuit against Lorance alleging gross negligence which resulted in the injuries to Mr. Sligh. As a result of that lawsuit, a $5 million judgment for compensatory and punitive damages was rendered against Mr. Lorance in favor of the plaintiffs William Sligh and his wife, Lucy Sligh.

As it turned out, Mr. Lorance had no assets other than his interest as beneficiary of two spendthrift trusts established by his mother in 1984 and 1988, respectively, before she died in 1993. First National Bank of Holmes County was the trustee of both trusts.

The trust agreements both included spendthrift provisions which specifically provided that "no part of this Trust, either principal or income, shall be liable for the deaths of said Gene Lorance, nor shall the same be subject to seizure by any creditor of his . . ."

On June 29, 1994, Mr. and Mrs. Sligh filed a separate lawsuit in an effort to seize the assets of the trusts, to the extent of their judgment. The plaintiffs alleged that the settlor of the trust, Edith Lorance, had actual knowledge of her son's habitual drinking habits and the fact that he had been unsuccessfully treated for alcoholism and that he was mentally deficient and had been previously committed to mental institutions. He had impaired facilities due to his alcoholism and mental disorders, and that he regularly operated motor vehicles while intoxicated. The complaint went on to allege that despite her actual knowledge of these facts, Ms. Lorance established the two trusts as part of her intentional plan and design to enable her son to continue to lead his "intemperate, debauched, wanton and depraved lifestyle while at the same time shielding his beneficial interest in the trust from the claims of his involuntary tort creditors." As a result, the Slighs alleged that it would be a violation of public policy to enforce and give priority to spendthrift trust provisions over involuntary tort judgments against the beneficiary. They urged the court to recognize and enforce a public policy exception to the spendthrift trust doctrine in favor of involuntary tort creditors by subjecting Lorance's beneficial interest to the payment of their tort judgment in one or more of several equitable ways suggested in their complaint.

The Supreme Court of Mississippi held that, "as a matter of public policy. . . a beneficiary's interest in spendthrift trust assets is not immune from attachment to satisfy the claims of the beneficiary's intentional or gross negligence tort creditors." In arriving at its holding, the court acknowledged the four exceptions to the rule prohibiting the invasion of a spendthrift trust enumerated in the Restatement, i.e., claims: for support of child or wife; for necessaries; for "services rendered and materials furnished which preserve or benefit the interest of the beneficiary; for State or federal taxes, Id. at 1026, quoting Restatement (Second) of Torts, § 157, and a fifth, when the trust is "a self-settled trust, i.e., where the trust is for the benefit of the donor," it had itself recognized Id., citing Deposit Guaranty Nat'l Bank v. Walter E. Heller & Co., 204 So. 2d 856, 859 (Miss. 1967). Conceding that § 157 of the Restatement does not list an exception for involuntary tort creditors, the court found support for its position in Comment a to that section, which, as we have seen, admits of the possibility of a tort claimant with a claim against the beneficiary of a spendthrift trust being able to reach that beneficiary's interest. Sligh, *supra*, 704 So. 2d at 1026. It also was persuaded by those portions of Scott, The Law of Trusts and Bogert, Trusts and Trustees, quoted herein and to which the appellant referred us. Id. at 1027. Finally, the court rejected the three public policy considerations it identified from its own precedents upholding the validity of spendthrift trust provisions: "(1) the right of donors to dispose of their property as they wish; (2) the public interest in protecting spendthrift individuals from personal pauperism, so that they do not become public burdens; and (3) the responsibility of creditors to make themselves aware of their debtors' spendthrift trust protections." Id. at 1027.

Thus, the court found, in a 7-2 decision, that, as a matter of public policy, a beneficiary's interest in spendthrift trust assets was not immune from attachment to satisfy the claims of the beneficiary's intentional or gross negligence tort creditors, and that such claims took priority over any remainder interest in such assets. However, the dissenting justices, while numbering only two, wrote a two-paragraph dissent which, in the long run, had a farther reaching effect than anyone could have ever contemplated. In the dissent written by Justice Prather, and joined by Justice J. Smith, Justice Prather wrote:

> "I must respectfully dissent to the limitations placed by the majority on the exempt status of spendthrift trust benefits. The majority acknowledges that Louisiana is the only other State to place such limitations on spendthrift trust benefits for tort creditors, and said limitations were implemented by the Louisiana legislature rather than the courts of said state. This Court is thus, apparently, the first to so limit the exempt status of spendthrift trust benefits. I am aware of the public policy considerations which motivated the majority's decision, but, in my view, the general rule favoring the exempt status of spendthrift trusts benefits is a sound one which is in no need of revision.
>
> "Spendthrift trusts provide a means for a parent or other concerned party to provide for the basic needs of a beneficiary, and the largely exempt status of the trust benefits has given comfort and support to countless settlors and beneficiaries. The facts of the present case are tragic, but this Court should, in my view, avoid changing longstanding precedent based on the fact pattern of a particular case. Creditors in this state have at their disposal a number of means of collecting judgments, and I fear that the majority opinion signals the start of a gradual decline of the spendthrift trust in this state. I would affirm the ruling of the trial court, and I must accordingly dissent."

The concise and accurate articulation of historical spendthrift trust protection offered by the dissent in the Sligh case apparently was not lost on many in Mississippi and, in particular, the Mississippi Legislature. A mere five months after the decision in Sligh, effective March 23, 1998, the Mississippi Legislature passed the Family Trust Preservation Act of 1998. Miss. Code Ann. § 91-9-503 (2003), effectively overruling the decision in Sligh by providing that:

> "Beneficiary's Interest not subject to transfer; restrictions on transfers and enforcement of money judgments,
>
> "Except as provided in Section 91-9-509, if the trust instrument provides that a beneficiary's interest in income or principal or both of a trust is not subject to voluntary or involuntary transfer, the beneficiary's interest in income or principal or both under the trust may not be transferred and is not subject to the enforcement of a money judgment until paid to the beneficiary."

The speed at which the Mississippi Legislature moved to overturn the decision in Sligh did not go unnoticed. In an article appearing in the California Law Review shortly after the decision was rendered, an article on the overall trend in this area of the law wrote:

> "An almost amusing reversal of direction was the prompt 1998 legislation in Mississippi to overturn the widely acclaimed Sligh v. First National Bank. Sligh had introduced a policy-based spendthrift exception for the benefit of victims of a beneficiary's gross negligence or recklessness. Furthermore, lengthy and vigorous debates in the last few years have eventually led to no significant changes or trends in rules identifying privileged claimants who can penetrate the spendthrift shield. This is particularly so with reference to privileged status that applies to certain governmental claimants, and often applies to alimony and the support claims of children and spouses and to certain claims for necessities and for protection of a beneficiary's trust interest."[29]

A similar attempt to pierce a spendthrift trust was attempted in the New Hampshire case of Laurie Scheffel, individually and as next friend of Cory C. v. Kyle Krueger, et al. In the Scheffel case, Ms. Scheffel alleged that the defendant, Kyle Krueger, had sexually assaulted her minor child. The same conduct that the plaintiff alleged in the tort claim also formed the basis of criminal charges against the defendant. The court entered a default judgment against defendant and ordered him to pay $551,286.25 in damages. To satisfy the judgment against the defendant, the plaintiff sought an attachment of the defendant's beneficial interest in the Kyle Krueger Irrevocable Trust. The trust had been established by the defendant's grandmother in 1985 for the defendant's benefit. The trust agreement included a spendthrift trust provision which prohibited the beneficiary from making any voluntary or involuntary transfers of his interest in the trust. Specifically, Article VII of the trust agreement provided as follows:

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[29] Symposium on Law in the Twentieth Century: Uniform Acts, Restatements, and Trends in American Trust Law at the Century's End. 88 Calif. L. Rev. 1877.

> "No principal or income payable or to become payable under any of the trusts created by this instrument shall be subject to anticipation or assignment by any beneficiary thereof, or to the interference or control of any creditors of such beneficiary or to be taken or reached by any legal or equitable process in satisfaction of any debt or liability of such beneficiary prior to its receipt by the beneficiary."

The trial court had dismissed the plaintiff's claim for relief, holding that the spendthrift provision was enforceable against the plaintiff's claim under state law. Nevertheless, the plaintiff on appeal, argued that the legislature did not intend for state law to shield the trust assets from tort creditors, especially when the beneficiary's conduct constituted a criminal act.

At the time, the statute in New Hampshire provided only two exceptions to the enforceability of spendthrift provisions. Specifically, state law provided that spendthrift trust protection "shall not apply to a beneficiary's interest in a trust to the extent that the beneficiary is the settlor of the trust and the trust is not a special needs trust established for a person with disabilities", and "shall not be construed to prevent the application of [fraudulent transfer laws]." Since it was clear that neither of the two foregoing exceptions applied to the plaintiff's case, the plaintiff's sole recourse was to argue that public policy required the court to create a tort creditor exception to the statute.

After reviewing the history of the spendthrift trust exceptions under state law, the New Hampshire Supreme Court held that the state legislature had enacted a statute specifically providing for only two exceptions, thereby repudiating any other exceptions to the law. Thus, the statutory enactment could not be judicially overruled because "it is axiomatic that courts do not question the wisdom or expediency of a statute." citing Brahney, 87 N.H. 298. Therefore, no rule or public policy was available to overcome this statutory rule.

VIII. THE DOMESTIC ASSET PROTECTION TRUST ("DAPT")

Historically, while trusts have been very popular and widely used in the United States for a variety of purposes, a "self-settled" trust, that is, one that is established for the benefit of the settlor, have been seen as being against public policy and therefore, until recently, prohibited in all 50 states. The general rule against self-settled trusts was found for many years in the Restatement of Trusts, 2nd §156, which provided that:

> (1) Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interest.
> (2) Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.

The comments to the rule made it clear that the §156 prohibition against a self-settled trust was applicable even if the transfer into the trust was not a fraudulent conveyance. The interest of the settlor/beneficiary could therefore be reached by subsequent creditors as well as by those who were creditors at the time of the creation of the trust. It was immaterial that the settlor/beneficiary had no intention to defraud his or her creditors.

The rule against self-settled trusts was re-established in the recently published Restatement of Trusts, 3rd §58, which provides that:

> "A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid."

The foregoing restriction of §58(2) actually appears in the section of the Restatement which, with some exceptions, specifically protects a spendthrift trust that provides by its terms that a beneficiary's interest shall not be transferable by the beneficiary or subject to claims of the beneficiary's creditors.

In the Restatement's comments on the recodification of the rule against self-settled trusts in §58(2), it indicates that "occasional suggestions that the self-settled trust rule be re-examined have been uninfluential, and policy and rules in other areas of the law have been consistent with the rule here." The Restatement did acknowledge limited exceptions such as in the area of pension fund planning, particularly under ERISA.

Notwithstanding the historical rule against self-settled trusts in the United States, the trend to effectively eliminate the common law doctrine against self-settled trusts has followed the trend to reexamine and modify or abolish longstanding common law rules that, in a modern society, are deemed obsolete or no longer necessary.

The first state to go against the traditional prohibition against self-settled trusts was the state of Alaska. On April 1, 1997, Alaska adopted the Alaska

Trust Act, House Bill 101. Upon its enactment, the Alaska State Legislature issued a press release entitled "Measure to Strengthen Family Trust Becomes Law." The legislation was ostensibly designed to provide an "onshore" alternative to offshore trusts.

Not to be outdone, the state of Delaware almost immediately thereafter adopted its own legislation on July 9, 1997, when it adopted the Delaware Qualified Dispositions in Trust Act. Since its initial adoption, Delaware has been quite aggressive in regularly amending its statute in an effort to stay one step ahead of its growing competition. Since Alaska started the trend in 1997, seven additional states, thus bringing the overall total to eight states, have adopted legislation that effectively eliminated the common law rule against self-settled trusts and, in its place, adopted asset protection trust legislation expressly sanctioning the Domestic Asset Protection Trust ("DAPT"). The eight states, in order of adoption, are: Alaska (1997), Delaware (1997), Nevada (1999), Rhode Island (1999), Utah (2004), Oklahoma (2004), Missouri (2004), and, effective July 1, 2005, the state of South Dakota. Thus, despite the so-called "public policy" against self-settled trusts, the trend in the Untied States is following the well-established trend in offshore jurisdictions. Specifically, jurisdictions are finding that, for a qualified settlor who is not using such structures to defraud creditors, a self-settled trust is a valid and legitimate structure entitled to the benefits historically granted a non self-settled spendthrift trust.

A. Typical DAPT Statute.

Although all DAPT statutes have the same goal, they are by no means identical or even similar. For example, a glaring limitation of the Oklahoma statute is the $1 million "cap" that can be protected in an Oklahoma self-settled trust pursuant to that state's legislation. Also varying from state to state is the statute of limitations on fraudulent transfers (2 years versus 4 years) and the type of assets that can be held in a DAPT and even the location of those assets. Nevertheless, generally speaking, all of the domestic asset protection trust statutes have similar characteristics which include:

- **Self-Settled Trusts Permitted.** State law has been amended by statute to specifically allow the establishment of a "self-settled trust" wherein the settlor can also be a beneficiary of the trust, can receive benefits from the trust and yet protect those benefits from the claims of future creditors. By eliminating the rule against self-settled trust, DAPT states have ***theoretically*** eliminated one of the major obstacles to using a domestic trust for asset protection purposes.
- **Rule Against Perpetuities Abolished.** Admittedly, the Rule against Perpetuities is probably an anachronism that has outlived its usefulness. Most of the offshore jurisdictions have eliminated the Rule against Perpetuities as have some states. Thus, with the elimination or limitation on the Rule against Perpetuities, a DAPT can theoretically continue for several generations and, in some states, forever.
- **Secrecy and Confidentiality Protection.** Some states, such as Alaska, have attempted to adopt strong "secrecy" provisions into their asset protection trust legislation in an effort to protect the confidential nature of the trust and any related information including the identity of the beneficiaries of the trust and the assets of the trust. Of course, such legislation can only go so far. It can defend against the premature disclosure of information relating to the trust while litigation is still pending. Such information is obviously discoverable in a post-judgment environment and certainly discoverable by state and federal authorities. Nevertheless, states like Nevada have extended the right of privacy to the corporate arena by providing, for example, that the officers and directors of a Nevada based company can be "nominees," persons who are disclosed as having and exercising their legal capacity for the company when in fact they are acting on behalf of undisclosed principals. This allows an individual to serve as an officer, manager, or director of a Nevada company without having his or her name disclosed on public documents such as contracts or other documents that might be entered into as part of a business transaction or might actually be even available in the public records.
- **Retained Powers.** Many DAPT statutes allow the settlor of the trust to retain certain powers such as the power to veto distributions, to appoint advisors or trust protectors to the trust, or to retain the power to direct investments or appoint investment advisors to the trust. Some states even allow the settlor to remove and replace a trustee. The foregoing powers are essentially a retained control over the affairs of the trust which, in an offshore setting, would be an invitation to a court to force the settlor holding such powers to exercise them in favor of a creditor. However, in states that have adopted DAPT legislation, these powers are expressly sanctioned by law.
- **Redomiciliation to Offshore Jurisdiction.** As will be discussed below, there is great uncertainly associated with the effectiveness of domestic asset protection trusts. As a result, some states have adopted legislation that expressly allows a trustee

of a DAPT to redomicile the trust to a foreign jurisdiction if such redomiciliation is in the best interest of the beneficiaries and consistent with the planning goals of the settlor. By expressly providing in state law that such offshore redomiciliation is sanctioned, the trustee can take steps to effectively remove the trust and its assets from "harms way" by moving the trust offshore without fear of civil liability to the trustee since the redomiciliation is expressly sanctioned by statute.

B. Delaware Asset Protection Trust.

Shortly after Alaska adopted the first domestic asset protection trust legislation in the country, the state of Delaware adopted the Delaware Qualified Dispositions in Trust Act ("Delaware APT Statute") effective July 9, 1997, allowing the formation of a Delaware asset protection trust similar to that found in offshore jurisdictions containing statutory asset protection legislation. As with most Delaware business statutes, the Delaware legislature has continued to modify and refine the legislation since its initial adoption.

1. Qualified Dispositions

A "qualified disposition" under Delaware law is nothing more than a disposition by or from a transfer to a qualified trustee or trustees, with or without consideration, by means of a trust instrument. A qualified trustee is typically a person:

- who is licensed to act as a trustee by the state of Delaware; or is an individual resident of the state of Delaware;
- maintains or arranges for custody in Delaware of some or all of the property that is transferred to the trust; or
- is not the transferor or a non-resident of the state.

Property that may be transferred to a Delaware trust includes real property, personal property, and interest in real or personal property.

2. Retained Powers of Settlor.

The Delaware law provides that a Delaware asset protection trust shall be governed by a "trust instrument" which is an instrument appointing a qualified trustee or qualified trustees for the property that is subject of the disposition. The trust instrument must specifically incorporate the law of the state of Delaware to govern the validity, construction, and administration of the trust. However, what is quite appealing to many individuals are the powers that may be retained by a settlor of a Delaware trust. Of course, to be effective from an asset protection trust, the trust must be irrevocable. However, Delaware law provides that a trust instrument shall not be deemed revocable on account of its inclusion of one or more of the following:

- A transferor's power to veto a distribution from the trust;
- A power of appointment (other than a power to appoint to the transferor, the transferor's creditors, the transferor's estate or the creditors of the transferor's estate) exercisable by will or other written instrument of the transferor effective only upon the transferor's death;
- The transferor's potential or actual receipt of income, including rights to such income retained in the trust instrument;
- The transferor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust as such terms are defined in §664 of the Internal Revenue Code of 1986 [26 U.S.C. §664] and any successor provision thereto; and the transferor's right, at any time and from time to time by written instrument delivered to the trustee, to release such transferor's retained interest in such a trust, in whole or in part, in favor of a charitable organization that has or charitable organizations that have a succeeding beneficial interest in such trust;
- The transferor's receipt each year of a percentage (not to exceed 5) specified in the trust instrument of the initial value of the trust assets or their value determined from time to time pursuant to the trust instrument or of a fixed amount that on an annual basis does not exceed 5% of the initial value of the trust assets;
- The transferor's potential or actual receipt or use of principal if such potential or actual receipt or use of principal would be the result of a qualified trustee's or qualified trustees' acting:

  a. In such qualified trustee's or qualified trustees' discretion;
  b Pursuant to a standard that governs the distribution of principal and does not confer upon the transferor a substantially unfettered right to the receipt or use of the principal; or
  c. At the direction of an adviser described in Section 3570(9)(c) of the Delaware APT Statute who is acting (a) in such adviser's discretion; or (b) pursuant to a standard that governs the distribution of principal and does not confer upon the transferor a substantially

unfettered right to the receipt of or use of principal.

For purposes of the above paragraph, a qualified trustee is presumed to have discretion with respect to the distribution of principal unless such discretion is expressly denied to such trustee by the terms of the trust instrument.

- The transferor's right to remove a trustee or adviser and to appoint a new trustee or adviser (other than a person who is a related or subordinate party with respect to the transferor within the meaning of §672(c) of the Internal Revenue Code of 1986 [26 U.S.C. §672(c)] and any successor provision thereto);
- The transferor's potential or actual use of real property held under a qualified personal residence trust within the meaning of such term as described in §2702(c) of the Internal Revenue Code of 1986 [26 U.S.C. §2702(c)] and any successor provision thereto or the transferor's possession and enjoyment of a qualified annuity interest within the meaning of such term as described in Treasury Regulation §25.2702-5(c)(8) 26 C.F.R. 25.2702-5(c)(8)] and any successor provision thereto;
- The transferor's potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on income of the trust if such potential or actual receipt of income or principal is pursuant to a provision in the trust instrument that expressly provides for the payment of such taxes and if such potential or actual receipt of income or principal would be the result of a qualified trustee's or qualified trustees' acting:

  a. In such qualified trustee's or qualified trustees' discretion; or
  b. At the direction of an adviser described in the Delaware APT Statute who is acting in such adviser's discretion.

Distributions to pay income taxes made under discretion included in a governing instrument may be made by direct payment to the taxing authorities.

3. Trust Protector.

The Delaware APT Statute allows for the concept of a trust protector similar to that found in offshore jurisdictions. Although the statute provides that only a "qualified trustee" may serve as a trustee of a Delaware asset protection trust, Section 3570(9)(c) provides that while neither the transferor nor any other natural person who is a nonresident of Delaware nor an entity that is not authorized by the law of this State to act as a trustee or whose activities are not subject to supervision as provided in the statute shall be considered a qualified trustee; however, nothing in the Delaware APT Statute precludes a transferor from appointing one or more advisers, including but not limited to:

- Advisers who have authority under the terms of the trust instrument to remove and appoint qualified trustees or trust advisers;
- Advisers who have authority under the terms of the trust instrument to direct, consent to or disapprove distributions from the trust; and
- Advisers described in §3313 of the "Decedents Estates and Fiduciary Relations" provisions of the Delaware Code, whether or not such advisers would qualify as a "Qualified Trustee".

For purposes of the Delaware APT Statute, the term "adviser" includes a trust "protector" or any other person who, in addition to a qualified trustee, holds one or more trust powers.

It should be noted that use of a Trust Protector who in an independent professional fiduciary or an individual who takes the role seriously, can go a long way in helping avoid many of the trust piercing problems that can occur when a domestic trust had a trustee who is an individual who is not knowledgeable about his or her responsibilities as a trustee or in those situations where the trustee and the beneficiary have a conflict of interest of some kind, especially in those situations where the trustee is also the beneficiary. A significant number of states have now adopted state law, such as what Delaware did, that adopts offshore style trust protector legislation into their state trust codes. Moreover, the trust protector does not need to be one entity or individual. It is not uncommon to have a "committee" of three (3) individuals who serve as a protector committee. These individuals usually consist of one or two professional advisor as well as close family friends who know the settlor well. A sample form of language than can be used to incorporate a trust protector into a domestic trust agreement is included herein as an Exhibit to this paper.

4. Fraudulent Transfers.

Any transfer into a Delaware trust is subject to the fraudulent transfer provisions found in the Delaware APT Statute which incorporate many of the state's normal fraudulent transfer provisions. However, there are significant exceptions. Section 3572 of the Delaware APT Statute provides that no action of any kind, including, without limitation, an action to enforce

a judgment entered by a court or other body having adjudicative authority, shall be brought at law or in equity for an attachment or other provisional remedy against property that is the subject of a qualified disposition or for avoidance of a qualified disposition unless such action shall be brought pursuant to the provisions of §1304 or §1305 of the Delaware Fraudulent Transfers Statute. The Delaware Court of Chancery has exclusive jurisdiction over any action brought with respect to a qualified disposition. However, in any action described in the foregoing sections, ***the burden to prove the matter by clear and convincing evidence is upon the creditor***.

Section 3573 of the Delaware APT Statute provides that, notwithstanding the limitations imposed by §3572, the limitations on actions by creditors to avoid a qualified disposition shall not apply:

- To any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony in favor of such transferor's spouse, former spouse or children, or for a division or distribution of property in favor of such transferor's spouse or former spouse, but only to the extent of such debt. However, the foregoing exception does not apply to any claim for forced heirship, legitime[30] or elective share; or
- To any person who suffers death, personal injury or property damage on or before the date of a qualified disposition by a transferor, which death, personal injury or property damage is at any time determined to have been caused in whole or in part by the tortious act or omission of either such transferor or by another person for whom such transferor is or was vicariously liable but only to the extent of such claim against such transferor or other person for whom such transferor is or was vicariously liable.

C. Potential Pitfalls and Unresolved Issues.

Notwithstanding the obvious advantages of domestic "onshore" asset protection trusts, several obvious issues and many potential pitfalls still exist. The effectiveness of DAPT legislation is not without its share of intelligent and articulate proponents and equally qualified critics. For example, the federal bankruptcy law that has been relied upon to protect a "spendthrift trust" has been cited for the authority that a domestic DAPT will even be recognized in a bankruptcy setting. Bankruptcy Code §541(c)(2) provides that a "restriction on the transfer of a beneficial interest of a debtor in a trust that is enforceable under applicable non-bankruptcy law" is to be honored in bankruptcy. While the foregoing legislation was adopted when all states had a general prohibition against protecting a self-settled trust, even some bankruptcy judges have recently acknowledged in unofficial settings that the foregoing language may require a bankruptcy court to give deference to a domestic asset protection trust. Others would argue that a bankruptcy judge is already required, like a federal judge, to apply the law of the jurisdiction in which the proceedings are pending for purposes of identifying the debtor's interest in property. Thus, if bankruptcy proceedings are commenced by or against a debtor in a state that does not recognize self-settled trusts, it could be argued that the trust is not entitled to the protection of §541(c)(2) since it is not an enforceable trust under the non-bankruptcy law of the state in which the proceedings are pending. Of course, such argument would not be available in a state that actually sanctions domestic asset protection trusts.

There are other disadvantages to a DAPT under current law.

- **Subject to U.S. Jurisdiction.** Trusts and assets located within a DAPT state are still within the jurisdiction of U.S. federal courts. Federal courts have nationwide jurisdiction which is superior to that of any state court. A trustee in a DAPT state will be hard pressed to avoid responding to a federal court's claim of jurisdiction.
- **Full Faith and Credit Clause.** Possibly the biggest legal hurdle to domestic asset protection trusts is the "full faith and credit" clause of the U.S. Constitution which requires that each state of the Union is required to recognize the judgments rendered by the courts of another state. In fact, Alaska and other DAPT states have previously adopted the Uniform Foreign Money Judgments Act.
- **Supremacy Clause.** While federal judges are bound by state law on most matters of substantive law, that certainly does not apply in the case where federal law has preempted state law including (1) matters of federal income taxation and (2) the power and the extent of the jurisdiction and authority of the bankruptcy court and bankruptcy trustee. Clearly assets transferred into a DAPT by a settlor should be reachable by the Internal Revenue Service or other agencies of the federal government to the extent of the settlor's interest in the trust.

30 "Legitime" is a child's equivalent to the "elective share" of a surviving spouse in a decedent's estate.

D. Future of Domestic Asset Protection Trusts.

The mere fact that eight states have effectively abolished the common law rule against self-settled trusts, with more states considering doing so, is evidence of the fact that today's litigious society is moving more and more towards allowing a solvent individual to take steps to protect his or her assets, so long as such action is not being done to delay, hinder, or defraud creditors. In fact, as discussed in the section on Bankruptcy Reform above, Congress clearly had before it the opportunity to effectively eliminate the growing trend toward the use of self-settled trusts both domestically and offshore. Yet, Congress ***expressly*** declined to do so, instead electing to allow a bankruptcy trustee to set aside transfers into such trusts when they are made with actual intent to delay, hinder or defraud and creditor. While domestic asset protection trusts still face many unresolved issues, they are certainly an alternative that should be considered for asset protection purposes, particularly those not inclined to pursue an offshore solution. However, it is too early to tell whether domestic asset protection trusts will be as effective as their proponents hope they are.

Individuals living within states that have actually adopted domestic asset protection trust legislation certainly stand a much better chance of being able to protect their structure than those individuals who reside outside of those states but nevertheless form a DAPT in the hopes that such trusts will eventually be recognized by the U.S. courts. Nevertheless, while there have been at least two cases involving litigation where the validity of a DAPT was placed into question, both cases were settled before trial. Thus, to date, there is no authoritative case law to support the proposition that domestic asset protection trusts will ultimately receive the same level of respect and recognition that is currently available to non self-settled spendthrift trusts.

IX. ATTACKS ON DOMESTIC FAMILY LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES.

The family limited partnership (FLP) is the traditional workhorse of gift and estate tax practitioners. It has many advantages over other less flexible alternatives. Unlike an irrevocable trust, the FLP can be amended to respond to changing business, family, and legal needs. From a tax standpoint, the ability to make special allocations of income and deductions presents significant income tax planning possibilities. However, that same flexibility allows the FLP to be drafted to facilitate the preservation and orderly transition of family wealth and managerial control from one generation to the next. While family limited partnerships are probably best known for the valuation discounts available when valuing an undivided interest in an FLP for federal gift and estate tax purposes, a less publicized advantage of an FLP is the asset protection's feature available under the law of many domestic and international jurisdictions that can be just as important as tax savings to the overall goal of family wealth preservation.

The asset protection attributes of a family limited partnership derive from statutory as well as non-statutory sources. The limitations and restrictions found within the partnership agreement itself provide various tools that can be used to preserve partnership assets and the interest of the family members in the partnership. Otherwise attractive and valuable assets to a creditor are made less so when they are transferred to and held by a family limited partnership. Assuming the partners have respected the family limited partnership as a separate and distinct legal entity separate from themselves, a creditor of one or more partners will be unable to reach partnership assets to satisfy its claim against any of its partners since the assets of the partnership are owned by the partnership, not the individual partners.[31]

Moreover, should the creditor attempt to instead seize the debtor partners' interest in the family limited partnership, the "charging order" limitation found in virtually all state limited partnership laws will likewise frustrate a creditor's efforts. The charging order limitation, discussed in detail below, is made available by state statute and significantly limits the recourse available to a creditor seeking recourse against a judgment debtor's interest in a partnership. Generally speaking, the partnership interest cannot be seized or sold, unlike other non-exempt personal assets. Instead, the "charging" creditor becomes a mere assignee of the judgment debtor with respect to his partnership interest. State law generally accords an assignee of a partnership interest little or no rights other than the right to receive distributions made with respect to the "charged" interest. These limitations on the rights of a partner's creditors enhance the value of the family limited partnership as an important family wealth preservation vehicle.

Notwithstanding the popularity of FLPs, the use and popularity of the domestic limited liability company (LLC) has also increased since it was first introduced to this country in 1976. The domestic LLC is designed to bring together in a single business organization the best features of all other business forms. Properly structured, its owners obtain both a

31 Revised Uniform Partnership Act (1994) (RUPA) §203 and 501.

corporate styled liability shield for its members and the pass-through tax benefits of a partnership.[32] However, despite its unique background and purpose, the LLC has yet to gain the widespread use and acceptance enjoyed by the traditional FLP for gift and estate tax planning purposes. However, its asset protection benefits, especially when combined with an FLP, makes the domestic LLC a very valuable asset protection tool when structuring a family wealth preservation plan.

While the FLP and LLC have multiple business and tax benefits associated with their use, this paper will focus on the asset protection benefits available under state law, especially when they are used together in designing a client's wealth preservation structure. However, it should be noted that the planning techniques discussed in this paper assume that the transfer of assets to the FLP or LLC do not involve fraudulent transfers under state law or federal bankruptcy law. Moreover, since some of the techniques described in this paper are, by their own admission, effective to thwart the collection efforts of the Internal Revenue Service, it is particularly important for the client's professional advisor to document and be satisfied that the transfer of assets to a FLP or LLC do not violate federal law prohibitions against actions designed to defeat the collection of tax imposed by the Internal Revenue Code.[33]

A. The "Charging Order" Limitation.

The charging order limitation found in most state partnership laws derives from Section 703 of the Revised Uniform Limited Partnership Act (the RULPA) which has been adopted, in one form or another in virtually all states.[34] The comments in RULPA regarding charging orders are unusually brief. However, the underlying history and roots of the charging order limitation were discussed at length in the oft-quoted California case of Taylor v. S & M Lamp Co.[35]

> "Prior to California's adoption of the Uniform Partnership Act (Corp. Code, §15001 et seq.), a judgment creditor of a partner whose personal debt, as distinguished from partnership debt, gave rise to the judgment, could cause a sale at execution of partnership assets, including specific items of partnership property, to satisfy his judgment...
>
> Lord Justice Lindley gave the following reason for the English rule forbidding execution sale of a partner's interest in the partnership to satisfy his non partnership debt:
>
> When a creditor obtained a judgment against one partner and he wanted to obtain the benefit of that judgment against the share of that partner in the firm, the first thing was to issue a *fi. fa.*, and the sheriff went down to the partnership place of business, seized everything, stopped the business, drove the solvent partners wild, and caused the execution creditor to bring an action in Chancery in order to get an injunction to take an account and pay over that which was due the execution debtor. A more clumsy method of proceeding could hardly have grown up.
>
> It was to prevent such "hold up" of the partnership business and the consequent injustice done the other partners resulting from execution against partnership property that the quoted code sections and their counterparts in the Uniform Partnership Act and the English Partnership Act of 1890 were adopted. As we view those code sections they are not intended to protect a debtor partner against claims of his judgment creditors where no legitimate interest of the partnership, or of the remaining or former partners is to be served."[36]

32 Uniform Limited Liability Act (1996) Prefatory Note.

33 Federal law provides that anyone who "removes, deposits or conceals" assets with intent to evade or defeat the collection of any tax imposed by the Internal Revenue Code shall be guilty of a felony and, upon conviction, fined $100,000 or imprisoned for not more than 3 years, or both. I.R.C. § 7206(4).

34 Revised Uniform Limited Partnership Act (1976) (RULPA) §703. "On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only its rights of an assignee of the partnership interest. This [Act] does not deprive any partner of the benefit of any exemption laws applicable to his [or her] partnership interest."

35 Taylor v. S & M Lamp Co., supra, 190 Cal. App. 2d 700, Rptr. 323 (1953).

36 Taylor v. S & M Lamp Co., 190 Cal. App. 2d 700, 12 Cal Rptr. 323.

Thus, the charging order evolved as a way to divert the debtor's share of the partnership profits and surplus to his creditors without disrupting the ongoing partnership. The charging order operates, in effect, as a substitution for execution on a partner's interest in the limited partnership.[37] Once charged, the judgment creditor has only the rights of an assignee of the partnership interest.[38] As an assignee, a creditor has the right to receive distributions to which the debtor partner would have been entitled; however, the charging order does not entitle the creditor to become or to exercise any rights of a partner.[39] As an assignee of a partnership interest, the creditor may not become a limited partner unless all other partners consent, something unlikely to occur.[40] The creditor cannot vote on partnership matters, inspect or copy partnership records, or even obtain from the general partner business and tax information regarding the affairs of the limited partnership that are usually available to limited partners as a matter of law.[41] Moreover, in a family limited partnership, the general partner will likely be a family member sympathetic to the plight of the partner who has been subject to the creditor's charging order. Thus, it is unlikely that the general partner would elect to make a cash distribution to partners which would entitle the creditor/assignee to a distribution.

B. The Limited Liability Company Alternative.

The domestic limited liability company was first introduced into the United States in 1976 by Wyoming and has since been adopted by all 50 states and the District of Columbia. Unfortunately, state limited liability company statutes display what the National Conference of Commissions on Uniform State Laws called a "dazzling array of diversity."[42] In an effort to promote uniformity among the states, the Conference in 1996 adopted the Uniform Limited Liability Company Act (ULLCA).

Since one of the stated purposes of the Act was to incorporate the best features of other business forms, the ULLCA incorporated the concept of the charging order limitation into the Act. Section 504 of the ULLCA, while providing for the concept of a charging order, further provides that a limited liability membership interest may be subject to judicial foreclosure by order of a court.[43] However, not all states have adopted this broad language in their state laws. For example, Section 4.06 of the Texas Limited Liability Company Act adopts that portion of the ULLCA which allows a creditor of a member of a limited liability company to obtain a charging order against that member's membership interest. However, the Texas legislation excludes all of the language found in the ULLCA which outlines the various remedies of a creditor holding a charging order, including the remedy of foreclosure. Curiously, the foreclosure language is found in the language governing a charging order against a limited partnership under the Texas Revised Uniform Limited Partnership Act.[44] The fact that the foreclosure remedy is found in the Texas Uniform Limited Partnership Act but not in the Texas Uniform Limited Liability Company Act is clearly strong evidence of the legislative intent on the part of the Texas legislature to exclude the foreclosure remedy to a creditor holding a charging order against a member's interest in a limited liability company.

Whether or not foreclosure is available to a creditor, many state LLC statutes provide that a judgment creditor has only the rights of an assignee of the LLC interest so charged.[45] For example, in Delaware, an assignee of a member's limited liability company interest has no right to participate in the management of the business and affairs of a limited liability company except as provided in the LLC operating agreement and upon (a) the approval of all of the members of the LLC other than the member assigning his LLC interest or (b) compliance with any procedure provided for in the LLC operating agreement.[46] However, since the judgment creditor, as an assignee, is entitled to the member's share in the profits and gains of the LLC,[47] the judgment creditor may be taxable on its pro rata share of taxable income

37 Union Colony Bank v. United Bank of Greeley Nat'l Ass'n, 832 P.2d 112.

38 RULPA §703.

39 RULPA §702.

40 RULPA §704(a). An assignee may also become a partner if the assigning partners grant the assignee that right in accordance with the partnership agreement, something which is unlikely to be given the assignor is an uncooperative judgment debtor.

41 RULPA §305.

42 See Footnote 2.

43 ULLCA §504.

44 Texas Revised Limited Partnership Act §7.03.

45 See i.e. Del. Code title 6, §18-703.

46 Del. Code title 6, §18-702(a).

47 Id., §18-702(b)(1).

from the LLC.[48] As with a limited partnership interest, a creditor who utilizes a charging order to attach the membership interest of a debtor member will not welcome the prospect of having to report taxable income on income that has probably not been distributed to the creditor.

Assets transferred to an LLC are also protected from member's creditors.[49] Members of an LLC are neither co-owners of nor have a transferable interest in, property of an LLC.[50] Thus assets transferred to an LLC become the property of the LLC and not subject to the creditor claims of its individual members. Since a creditor's recourse against a member is limited to a charging order, assets transferred to an LLC can be effectively protected against levy and seizure by a creditor. This concept was recently illustrated in a IRS Chief Counsel advisory which held that the IRS may not levy on the assets of a single member LLC in order to satisfy the individual tax liability of the sole member-owner. The mere fact that the entity was disregarded as a separate entity under IRS "Check the Box" Regulations[51] did not legally justify an IRS levy on the assets of the LLC since property rights in those assets are governed under state law. Since state law provided that the assets sought to be levied upon were the property of the LLC and not the individual member, the individual taxpayer-member did not have a property interest in those assets that the IRS could levy upon.[52]

The Chief Counsel did note that the IRS had other collection options available including a levy against distributions from the LLC to the individual member. However, even the IRS must wait until those distributions are made. Moreover, state law does not usually provide creditors with the same collection remedies available to the IRS, particularly if the distributions from the LLC are classified as wages or salary exempt from creditor attachment under state law.[53]

48 Rev. Rul. 77-137, 1977 CB 178.

49 This assumes that the transfer is not subject to attack as a fraudulent conveyance under state law should the transferring member already be insolvent.

50 ULLCA §501(a).

51 Regs. 301.7701-3(b).

52 CCA 199930013.

53 Wages payable in Texas are fully exempt from creditor claims, except for child support claims, and may not be attached or garnished by a creditor. Tex. Prop. Code Ann. §42.001(b)(1).

C. Delaware Adopts Unambiguous Charging Order Protection.

Unfortunately, over a course of several years, many courts have interpreted state law to allow a creditor to also seek a foreclosure of a partner's interest in a partnership. Once a foreclosure occurs, the partner losses his or her interest in the partnership. This remedy came about primarily because of ambiguous language in the Uniform Limited Partnership Act which implies, without specifically stating so, that foreclosure was a remedy to a creditor with a charging order against a partner's interest in a partnership when such interest is subject to a charging order. Therefore, effective August 1, 2005, the state of Delaware amended its limited partnership law to prevent such foreclosures.[54] In the language which accompanied the amendment to the statute that was eventually adopted, the sponsors of the amending legislation stated that the purpose of the proposed amendments was:

> ***"to clarify the nature of a charging order and provide that a charging order is the sole method by which a judgment creditor may satisfy a judgment out of the partnership interest of a partner or partner's assignee. Attachment, garnishment, foreclosure or like remedies are not available to the judgment creditor and a judgment creditor does not have any right to become or to exercise any rights or powers of a partners (other than the right to receive the distribution or distributions to which the partner would otherwise have been entitled, to the extent charged".***

The 2005 amendments to the Delaware Revised Uniform Limited Partnership Act also provide that the Court of Chancery of the State of Delaware has exclusive jurisdiction to decide all matters pertains to charging orders involving a Delaware limited partnership.[55]

The amendments pertaining to charging order protection that were made to limited partnership law in Delaware were also added to the Delaware Limited Liability Company Act.[56] Therefore, the state of Delaware has specifically provided that a creditor may not seize the interest of a partner in a limited

54 Del. Code title 6, §17-703.

55 Del. Code title 6, §17-703(f).

56 Del. Code title 6, §18-703.

partnership or a member in a limited liability company. The creditor's sole recourse is the charging order. Thus, should a partner find themselves in this unfortunate situation, these limitations on creditors under Delaware law should help to induce a settlement of an outstanding claim that a creditor might not otherwise be inclined to accept. The foregoing asset protection features of your family limited partnership are an essential part of the design that has been incorporated into your family limited partnership.

D. Texas Adopts the "Exclusive Remedy" Concept of Charging Orders.

During the regular session of the Texas Legislature in the spring of 2007, a member of the Texas House of Representatives was approached with the idea of modernizing the Texas limited partnership law so that Texas law would be as protective of a partner's interest in a limited partnership as that provided under Delaware law. Unfortunately, charging order protection is a concept that is not readily known to most attorneys or even members of a state legislature. Thus, after the House Legislative Council made an initial attempt to draft language to amend those portions of the Texas Organizations Code that govern a partner's interest subject to a charging order, your author was invited to contribute to the process by evaluating and proposing revisions to the work done by the Texas Legislative Council. Of course, Texas limited partnerships are currently governed by both the Business Organizations Code and its predecessor, the Texas Revised Limited Partnership Act. Thus, while the proposed revisions to the charging order protection for limited partnerships was excellent, no thought had, at the time, been given to amending the charging order protection applicable to Texas limited liability companies which are governed by either the Business Organizations Code or the older Texas Limited Liability Company Act.

It was the desire of sponsoring members of the legislation to keep the nomenclature of the revisions consistent with the nomenclature in both the Business Organizations Code and its predecessor statutes. Thus, while some of the wording might be somewhat different than that found in Delaware, the net effect was the same. Thus, for judgments obtained by a judgment creditor on or after September 1, 2007, the revisions made to the law governing charging orders in Texas under both the Business Organizations Code and its predecessor statutes is now virtually identical to that found in Delaware. However, clearly the most significant change in the law governing charging orders is the specific language added to the applicable statutes making it clear that the entry of a charging order is the exclusive remedy by which a judgment creditor may satisfy their judgment. For example, as revised, Section 153.256(d) of the Texas Organizations Code provides that a judgment creditor of a partner or of a partner's assignee may satisfy a judgment only out of a judgment debtor's partnership interest. The ambiguous language previously found in both the Business Organizations Code and the Texas Revised Limited Partnership Act which made reference to an implied right of foreclosure pursuant to an order of a Court was deleted in its entirety. As a result, since the revisions governing charging orders for limited partnerships and limited liability companies were made to both the existing Business Organizations Code and its predecessor statutes, the sole remedy of a judgment creditor is to satisfy a judgment out of the judgment debtor's partnership or membership interest by way of distributions to which the judgment debtor would have otherwise been entitled to.

E. Beware of Single Member LLCs.

Asset protection planning is only one of several very important issues that should be considered when choosing the appropriate entity for a client. However, if asset protection is one of the principal goals of the planning process, single member LLCs should be avoided.

In the recent U.S. bankruptcy case of In Re: Albright,[57] the debtor filed a Chapter 13 petition under the bankruptcy code that was later converted to a Chapter 7 liquidation. One of the assets of the estate was a single member LLC of which the debtor was the sole member and manager. The Chapter 7 bankruptcy trustee argued that because the debtor was the sole member and manager of the LLC at the time she filed bankruptcy, the Chapter 7 trustee had effectively stepped into the shoes of the debtor. Hence, the Chapter 7 bankruptcy trustee had become the "substituted" sole member of the LLC and, as such, could appoint new managers and/or vote to liquidate the LLC in its entirety. The debtor argued that the sole remedy of the trustee was to seek a charging order against distributions made on account of her LLC membership interest.

The court agreed with the trustee's position and held that the debtor's bankruptcy filing effectively assigned her entire membership interest in the LLC to the bankruptcy estate pursuant to 11 USCS §541, and that the trustee thereby obtained all of the debtor's rights, including the right to control the LLC management, since applicable law[58] provided that the members, including the sole member of a single

57 In Re Albright, 291B.R. 558; (Bankr. D. Colo. 2003).

58 Colo. Rev. Stat. §7-80-101 et seq.

member LLC, had the power to elect and change managers. Since the trustee became the sole member of the LLC upon the debtor's bankruptcy filing, then the trustee controlled all governances of the LLC, including all decisions related to a liquidation of the LLC's assets. This finding is particularly important since the LLC law of several offshore jurisdictions has been modeled after existing U.S. statutes.

Interestingly, notwithstanding its finding, the court admitted that under applicable law[59] the result would have been different had there been other non-debtor members in the debtor LLC.

> "Where a single member files bankruptcy while the other members of a multi-member LLC do not, and where the non-debtor members do not consent to a substitute member status for a member interest transferee, the bankruptcy estate is only entitled to receive the share of profits or other compensation by way of income and the return of contributions to which that member would otherwise be entitled."[60]

Many in the asset protection community had predicted the result in Albright years before it actually occurred. Now that it has, the decision underscores the importance of incorporating multiple members in an LLC if asset protection is an important goal in forming the entity, whether domestically or offshore. Moreover, as implied in Albright, the interest of the members should be more than *de minimis*. If the LLC is formed as part of the comprehensive business and estate plan, such a membership allocation should not be difficult. More importantly, any offshore structure should be avoided if there is a reasonable likelihood that the client will soon become a debtor in bankruptcy proceedings.

F. Exposure of FLP Partners & FLLC Members to Bankruptcy Trustee Superior Federal Powers.

Just as the Strangi case provided an unexpected weapon to the Internal Revenue Service to attack family limited partnerships and family limited liability companies, U.S. Bankruptcy Trustees have found and have recently been successful in utilizing the provisions of § 541 of the U.S. Bankruptcy Code to disregard all restrictions against the transfer of a partnership or membership interest, including those provided under state law, thus enabling the bankruptcy Trustee to step into the shoes of a bankrupt debtor who owns an interest in such an entity at the time of the filing of his bankruptcy Petition. Moreover, since the bankruptcy Trustee becomes a "substituted partner" or "substituted member" whether or not the entity or any of his partners concur, the bankruptcy Trustee becomes a "full member" in the estate planning structure, with any and all rights that the bankrupt debtor had in the estate planning structure before seeking bankruptcy protection. The result is a very powerful weapon in the arsenal of the bankruptcy Trustee, particularly when the bankrupt debtor might have a cause of action against the estate planning structure or any of its owners, typically, the matriarch and patriarch of the family for which the estate planning structure was created.

1. In Re: Ehmann.

As quoted above in the section discussing the Albright case, the bankruptcy court acknowledged that the result of that case would have been different had the LLC not been a single member LLC. Specifically, the court acknowledged that that the bankruptcy trustee would ***not*** step into the shoes of the debtor in bankruptcy if non-debtor members did not consent to substitute member status for a member's interest transferred as a result of a bankruptcy filing by the member/debtor. However, a different bankruptcy court reached an opposite conclusion in the 2005 case of In Re: Ehmann.[61]

In Ehmann, the bankruptcy trustee in the Chapter 7 bankruptcy proceedings of debtor Gregory L. Ehmann, filed a lawsuit against Fiesta Investments, LLC, an Arizona limited liability company of which the debtor was a member when his bankruptcy case was filed. The trustee's lawsuit sought a declaration that the trustee had the status of a member in Fiesta, a determination that the assets of Fiesta were being wasted, misapplied or diverted for improper purposes, and for an order dissolving and liquidating Fiesta or the appointment for a receiver for Fiesta. In response, Fiesta filed a motion to dismiss the complaint arguing that, under Arizona law and the Operating Agreement governing Fiesta, the trustee was a mere "assignee" and, as such, had rights that were limited to receiving a distribution that might have been made to the defendant if and when Fiesta decided to make such a distribution.

Critical to the resolution of Ehmann was two significant Bankruptcy Code provisions, §§541(c)(1) and 365(e)(2). Bankruptcy Code §365(e)(2) basically provides that a bankruptcy trustee may not assume or

59 Id., §7-80-702.

60 In Re Albright, *supra* note 40, at 540.

61 319 BR. 200 (2005).

assign any "executory contract" whether or not such contract prohibits or restricts assignments of rights or delegation of duties, if:

- applicable law excuses a party, other than the debtor, to such contract from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract prohibits or restricts assignment of rights or delegation of duty; and
- such other party does not consent to such assumption or assignment.

Although the Bankruptcy Code contains no definition of an "executory contract," the court essentially adopted the "Countryman" definition formulated by the Ninth Circuit which describes a contract as being executory if "the obligation of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other."[62] Thus, if the operating agreement with Fiesta was found to be an "executory contract," the restrictions in that operating agreement would be binding on the bankruptcy trustee.

However, after having examined all of the arguments made by Fiesta supporting the notion that the operating agreement was an "executory contract," the bankruptcy court found that the members had no binding unfulfilled obligations to the Fiesta, thus rendering the operating agreement a non-executory contract. Having made that finding, the bankruptcy court determined that Bankruptcy Code §541(c)(1) governed the status of the bankruptcy trustee in Fiesta.

Bankruptcy Code §541(c)(1) expressly provides that an interest of the debtor becomes property of the estate notwithstanding any agreement or applicable law that would otherwise restrict or condition transfer of such interest by the debtor. The court found that all of the limitations in the operating agreement, and all of the provisions of Arizona law on which Fiesta relied upon, constituted conditions and restrictions upon the member's transfer of his interest. Since Bankruptcy Code §541(c)(1) rendered those restrictions inapplicable, the court found that this necessarily implied that the trustee had all of the rights and powers with respect to Fiesta that the debtor held as of the commencement of the case. In other words, the bankruptcy trustee stepped into the shoes of the bankrupt debtor member as a ***full member*** of the LLC, not as an assignee. As such, the court found that the bankruptcy trustee had every right that the member had to complain about those transactions that had occurred within Fiesta prior to his bankruptcy filing, which is exactly what the trustee was attempting to do in its lawsuit against Fiesta.

On December 7, 2005, the Bankruptcy Court issued a ruling on the relief sought by the Chapter 7 trustee in its original motion. The court found that the debtor's parents, the parties who formed Fiesta for estate tax purposes, had operated Fiesta "as if it were a revocable living spendthrift trust."[63] The Bankruptcy Court therefore granted the trustee's motion to appoint a receiver "to operate (or dissolve and liquidate) the LLC in accordance with its business purposes, its operating agreement, and state law."

The Ehmann opinions were both issued in 2005 and have not yet been thoroughly examined by leading commentators in the bankruptcy and LLC/partnership arena. Moreover, by motion of the parties, the Court's opinion dated December 7, 2005 was withdrawn, at the request of the parties, after the parties to the litigation settled their dispute and entered into a settlement agreement which was conditioned upon the Court's withdrawal of its December 7, 2006 opinion. The Court was reluctant to do so but nevertheless withdrew its opinion in the interest of not prolonging the dispute for the unsecured creditors. However, the problems that occurred in Ehmann will likely resurface can be avoided if the operating agreement, and the obligation of the members to the LLC, is structured in such a way as to render the operating agreement an executory contract under bankruptcy law. Moreover, if family members are to receive an interest in an FLLC or an FLP as part of a client's estate planning objectives, the Ehmann problems can also be avoided if the gifts are made to a spendthrift trust or trusts for the benefit of the family members rather than to have the gift be made directly to that family member. If properly structured, such spendthrift trust will not be a part of the family member's bankruptcy estate pursuant to the provisions of §541(c)(2) of the Bankruptcy Code.[64]

62 Unsecured Creditors' Comm. v. Southmark Corp. (In re Robert L. Helms Constr. and Dev. Co., Inc.), 139 F3d 702 (CA-9, 1998). The Countryman Test is derived from the work of Professor Vern Countryman in "Executory Contracts in Bankruptcy," 57 Minn. L. Rev. 439 (1973). See also, 2 King, Collier on Bankruptcy, ¶ 365.02, n. 3 (15th ed.).

63 In re Ehmann, 334 B.R. 437, 2005 Bank. LEXIS 2382 (Bankr. D. Ariz., 2005)

64 The Bankruptcy Code excludes from the "bankruptcy estate" property of the debtor that is subject to a restriction on transfer enforceable under "applicable non-bankruptcy law." 11 U.S.C. §541(c)(2).

2. In Re: Baldwin.

The Strangi and Kimball cases, as well as several other recent cases, have helped to underscore the importance of properly documenting the multiple tax and business goals of a wealth planning structure. Regardless of the reasons for the structure, it would appear that the more valid purposes that an entity will serve its owners, the more likely it is to withstand court scrutiny. This became evident in the very recent bankruptcy case of In re: Trenton J. Baldwin, an Oklahoma bankruptcy case where the Chapter 7 Bankruptcy Trustee sought the dissolution of the family limited partnership in which the debtor had an interest. His primary authority for making such a request was the court's decision in In Re: Ehmann, together with language under Oklahoma law that specifically allowed a limited partner to seek dissolution of a partnership whenever it was no longer reasonably practical to carry on the business of the partnership.

In the Baldwin case, the debtors Frank and Carolyn Baldwin filed a Petition for Chapter 7 Bankruptcy relief in August 2004. Carolyn was a sole limited partner in a partnership created by her parents in 1994, pursuant to the Oklahoma Uniform Limited Partnership Act, Okla. Stat. tit. 54 §§ 141-171(2002). At the time of the filing of the Petition, Carolyn Baldwin owned a 99% interest in the partnership. The partnership's sole general partner was a trust consisting of Carolyn's parents as sole trustees. The Partnership Agreement granted exclusive management and control of the partnership and its assets to the general partner, which owned a 1% interest in the partnership. Further, the Partnership Agreement provided that "the limited partner shall not take any part in or interfere in any manner with the conduct or control of the business of the partnership as a defined term or have any right or authority to act for or on behalf of the partnership." The Partnership Agreement further provided that the partnership was to dissolve 50 years after execution of the Partnership Agreement unless dissolution occurred with the consent of the general partner or the general partner's death, incapacitation, insolvency or bankruptcy.

The partnership assets consisted of approximately 200 acres of undeveloped land that was partly timber and partly pasture, and a house that the partnership constructed on the land, in which the bankrupt debtor resided. The debtors maintained the house and paid the costs associated with it, including mortgages, taxes and utilities. They used the land, in part, for the grazing of cattle. The property had an estimated value of approximately $400,000.

Following the initiation of the bankruptcy proceedings, the Trustee filed the necessary proceeding against the partnership and the general partner seeking a declaration that Carolyn Baldwin's interest in the partnership now belonged to the bankruptcy estate and, therefore, the bankruptcy Trustee. The bankruptcy Trustee further requested that the bankruptcy court find that continuation of the partnership is in fact due to the general partner's refusal to recognize the estate's interest. At the trial, the bankruptcy court ruled in favor of the Trustee on both of these issues. The matter was thus appealed by the bankrupt debtor to the U.S. Bankruptcy Appellate Panel for the 10th Circuit.

On appeal, the 10th Circuit Bankruptcy Appellate Panel upheld the lower bankruptcy court's ruling with respect to the issue of whether or not the debtors' interest in the family limited partnership became property of the bankruptcy estate upon filing of the bankruptcy Petition. Although the debtor had argued that the Trustee's sole remedy was that of a Charging Order pursuant to Oklahoma partnership law,[65] the Court of Appeals agreed with the bankruptcy Trustee that the facts of the case were factually similar to two other cases which had held that a debtor's rights pursuant to a family limited partnership or limited liability company become property of the bankruptcy estate and may be exercised by the Trustee. Specifically, the appellate court cited the case of Samson v. Prokops (In re: Smith),[66] in which the court held that "limited partner has contractual rights arising from the partnership" that are "legal or equitable interest of the debtor within in the ambit of Section 541(a)(1) of the Bankruptcy Code and, as a result, become property of the bankruptcy estate." However, more relevant was the court's reliance on Mobitz v. Fiesta Investments (In re: Ehmann)[67] in holding that the lower court had concluded correctly that the "Trustee has all the rights and powers with respect to [the company] that the debtor held as of the commencement of the bankruptcy case."

Interestingly, the court acknowledged in a footnote that both the Smith and Ehmann cases discuss whether limited partnership agreements were "executory contracts" governed by 11 U.S.C. § 365, and concluded that unless a debtor owed such a material obligation to the partnership that the failure to perform it would relieve the partnership of its obligations to debtor, the debtor's limited partnership interest was a "property interest" governed by § 541, rather than by § 365 of the Bankruptcy Code.

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65 Okla. Stat. tit. 54, § 342 (2005).

66 185 B.R. 285 (Bankr. S.D. Ill. (1995).

67 In Re: Ehmann, 319 B.R. 200 (2005).

Therefore, the appellate court in In re: Baldwin concluded that the bankruptcy Trustee stepped into the shoes of the debtor with respect to the family limited partnership interest and could assert whatever rights the bankrupt debtor had as a partner under the Partnership Agreement and state law, including, under Oklahoma Law, the right to seek dissolution.

The Baldwin appellate court then focused on the issue of whether the bankruptcy Trustee, having stepped into the shoes of the debtor, could now exercise its right to require the dissolution of the family limited partnership pursuant to Oklahoma law.

In ordering the dissolution of the family limited partnership, the lower bankruptcy court had relied on Oklahoma law which specifically allows limited partners to seek dissolution of a partnership "whenever it is not reasonably practical to carry on the business [of the partnership] in conformity with the Partnership Agreement."[68] From the evidence at trial, the lower bankruptcy court had found that the general partner "does not recognize the [Trustee's] interest in the partnership as Trustee of the bankruptcy estate." Further, it found that the partnership no longer served any estate planning purpose. However, at trial, the bankrupt debtor's father had testified that the partnership was established in 1994 as part of his effort to remove assets from his estate for estate tax purposes. The debtor's father characterized the primary and continuing purpose of the partnership as estate planning, with the intent he would retain full management and control of the partnership assets during his lifetime. He further testified that the partnership had at one time invested in mutual funds for a small profit, that lumber from the property had been sold at a profit to his lumber company, and that the expected the property to appreciate in value, at which part the partnership might sell lots out of the 200 acres and/or develop a subdivision for profit. All of the partnership profits were put back into the partnership property. Thus, it was the opinion of the debtor's father that the partnership was part of his ongoing estate planning strategy.

After reviewing the record, the Court of Appeals stated that it was "left with a definite and firm conviction" that the lower bankruptcy court was mistaken in finding that the partnership no longer served an estate planning purpose. As was the limited liability company in *Ehmann*, the limited partnership was established to allow Mr. Bailey to retain complete control of the partnership assets during his lifetime, while at the same time removing them from his estate for estate tax purposes. This purpose was still being served and would continue to be served even if the partnership were to become totally inactive. In addition, at various times, the general partner had made, or attempted to make, profits for the partnership that were then reinvested in the property. Moreover, the partnership had, in the past, invested in real estate and other assets and contemplated continuing to do so at a profit.

The appellate court also noted that the Oklahoma statute on which the lower bankruptcy court had relied upon in dissolving the partnership required a finding that it was no longer "reasonably practical to carry on the business [of the partnership] in conformity with the Partnership Agreement." The lower bankruptcy court's rationale for finding this provision applicable was the fact that the general partner did not recognize the Trustee's interest in the partnership. However, the debtor's father had not testified that he could not or would not continue to carry out his duties as general partner in the event that the Trustee was found to have an interest in the partnership, nor did he testify that he would refuse to recognize the court determination of the Trustee's interest. Since, the Trustee held the bankrupt debtor's right with respect to the partnership, and since the bankrupt debtor had neither management power under the Partnership Agreement, nor any present right to dissolve or liquidate the partnership, then the bankruptcy Trustee could not either. Thus, since the partnership was continuing to operate as a allowed under the Partnership Agreement and Oklahoma law, the Court of Appeals concluded that the Trustee had no present right to force either dissolution of the partnership or liquidation of its assets.

Estate planners not familiar with the *Baldwin* case should review it carefully to consider language and duties that can be incorporated into the existing FLP and FLLC documents to help document the purpose of the partnership and the obligation of the general partners and the partnership to continue with the general purpose of the partnership, notwithstanding any future adverse events. Moreover, for purposes of protecting the interest of the partners in a partnership or members in a limited liability company, the estate planning benefits associated with the structure should not be hidden when combined with other valid business purposes for having the structure in place.

G. Drafting Strategies.

In addition to the benefits provided by applicable law, multiple planning and drafting options are available to the client's advisors to further protect the interest of the client and the client's family in the wealth preservation structure to be implemented to achieve these goals.

68 Okla. Stat. tit. 54, § 346 (2005).

1. Protective Language In Partnership Agreement.

Although applicable state law is important in identifying the remedies available to a creditor of a FLP partner, the planner should not overlook the significant benefits associated with including protective language in the FLP's partnership agreement.[69] Generally speaking, the terms and conditions of the partnership agreement will be binding upon assignees of a partner.[70] This includes creditors who obtain a charging order on the partnership interest of a partner.[71] A properly drafted partnership agreement should provide that the partnership or partners who are not affected by the creditor action would have the option to purchase the interest of a partner whose interest is subjected to a charging order. The partnership agreement can also provide that the purchase price shall be payable over an extended term of years at a favorable interest rate.

In addition to incorporating the right to purchase the interest of the charged partner, the partnership agreement should provide for a quick, simplified, and favorable method of valuing the interest of the charged partner. One method of accomplishing this is to provide for mandatory mediation and binding arbitration of any valuation dispute. The partnership agreement can go so far as to provide for the selection of arbitrators that are familiar with the proper valuation of a limited partnership interest in a FLP. The typical family limited partnership interest for which there is no ready market is often subjected to severe transfer restrictions or prohibitions that in turn severely depress the value of the charged partnership interest. All of the foregoing will serve to further diminish the value of the seized partnership interest to the creditor of the unfortunate partner who, in many cases, continues to enjoy the support of the partnership and its partners, particularly in a family setting.

As discussed above, the partnership agreement can further provide that any disputes regarding the valuation of the interest to be acquired shall be resolved by binding arbitration to be conducted by arbitrators familiar with the proper valuation of a limited partnership interest in a closely held FLP governed by a restrictive partnership agreement.

2. Use of an LLC as FLP General Partner.

When using a FLP for wealth preservation planning purposes, further asset protection is available by using a limited liability company as the general partner of the limited partnership. In a limited partnership, the general partners are jointly and severally liable for all of the debts and obligations of the limited partnership.[72] This personal liability to the general partner can be avoided by using a limited liability company as the general partner rather than the client in an individual capacity. Before the advent of limited liability companies, it was customary to use a regular corporation or Subchapter S corporation as the general partner of a limited partnership to avoid personal liability to shareholders of the corporate general partner. However, this left the shares of the corporate general partner subject to seizure and execution by a creditor of the corporate general partner shareholder. Assuming a creditor was able to obtain control of the corporate general partner, the creditor could theoretically gain control of the family limited partnership in its capacity as general partner. However, if the general partners consisted of one or more limited liability companies, a creditor's sole recourse, under Texas, Delaware and comparable state statutes,[73] is a charging order against the general partner's LLC interest. Thus, while the general partner's LLC interest would be subject to the charging order, the general partner's interest would not be subject to seizure and potential corresponding loss of control of the limited partnership. From an asset protection standpoint, it is clear that a properly structured LLC is usually the preferred entity to act as general partner of an LP or FLP.

3. Use of a Domestic Trust as Limited Partner.

The use of a family limited partnership usually involves limited partnership interests that have been gifted to family members. If the family members own the limited partnership interests in their individual capacities, their interests are subject to their own individual creditor claims should they arise, although the charging order limitations discussed in this paper certainly provide some protection and relief from such creditor action. However, another insulation of protection for the limited partnership interest can be obtained if the gift of the limited partnership interest is made to an irrevocable domestic trust rather than to the family member directly. If the trust was not involved in any other activity which would subject it to litigation risks, the limited partnership interest transferred to the domestic trust for the benefit of the family member can

69 The drafting strategies discussed in this section of this paper are equally applicable to LLCs.

70 RULPA §704(b).

71 RULPA §703.

72 RULPA §403(b).

73 Tex. Rev. Civ. Stat. Art. 1528n, §406; 6 Del. Code. Ann. §18-703.

effectively be protected from the potential creditor claims of the donee family member.

The domestic trust has been successfully utilized by practitioners as a crucial estate planning and wealth preservation planning tool for decades. Despite restrictions on the ability of a settlor to retain an interest in a domestic trust, a properly structured irrevocable trust, where the grantor has "cut the strings" in terms of benefit and control, has been, and still can be, successfully used to preserve the assets of the grantor for the benefit of his family.

One of the most common types of trust used in asset preservation is the spendthrift trust. A spendthrift trust is one which provides by its terms that the interest of a beneficiary in the income or principal of the trust may not be voluntarily or involuntarily transferred or otherwise alienated by the beneficiary, except as provided by the trust instrument. The legality of the spendthrift trust is recognized in virtually all states. For example, Chapter 112.035 of the Texas Trust Code provides that a settlor may provide in the terms of the trust that the interest of a beneficiary in the income or in the principal or in both may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee.[74] A declaration in a trust instrument that the interest of a beneficiary shall be held subject to a "spendthrift trust" is sufficient to restrain voluntary or involuntary alienation of the interest by a beneficiary to the maximum extent permitted by §112.035 of the Texas Trust Code.

A discretionary spendthrift trust provides even greater protection to its beneficiaries than a spendthrift trust which calls for specified distributions. In a discretionary trust, the trustee has sole and absolute "*discretion*" to decide the amount and the timing of income or principal distributions to the beneficiary. Typically, as long as property is held in trust and is subject to the terms of a spendthrift provision, the general rule is that property may not be reached by the creditors of a beneficiary of that trust. However, once the proceeds are distributed to the beneficiaries, they escape the protection of the clause and may be reached by creditors.[75] However, the broad discretionary powers of a trustee under an agreement which empowers the trustee full and absolute discretion in making distributions to beneficiaries constitutes a further restraint upon the ability of the beneficiaries of the trust to assign or in any manner alienate the income or the principal of the trust, and represents as well a further immunity from judicial process.[76] Although the courts will recognize that all property of a debtor shall be subject to reach in proper time and manner by his creditors, save only such property as may be legally exempt, the courts will generally not extend this policy to income of discretionary trust funds, which are held in trust for the ordinary and necessary living expenses of the beneficiary, at least until such funds are actually received and held by the beneficiary. Such income does not constitute "property" within the normal meaning of state statutes defining property which is available for execution.[77]

In First Northwestern Trust Co., the Eighth Circuit Court of Appeals declined to allow the claim of the Internal Revenue Service to reach the interest of beneficiaries in a family trust where the trustee had broad discretionary powers. The court held that the rights of the beneficiaries were contingent upon the discretionary authority of the trustee. The trust agreement gave the trustee the authority to distribute the trust funds in unequal amounts, and the agreement specifically provided that the trustee was only obligated to disburse "*such amounts as in the sole discretion of the Trustee as necessary, reasonable and proper, to such members of the [settlor's] family requiring such funds upon proper proof of such need to the satisfaction of the Trustee . . .*" The court found that there was no identifiable or ascertainable interest or right in the income until those two contingencies were met.

X. OFFSHORE FAMILY LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES - ENHANCED ASSET PROTECTION

As previously discussed, family limited partnerships are probably best known for the significant discounts available when valuing an undivided interest in a family limited partnership for federal gift and estate tax purposes. A less publicized advantage of a family limited partnership is the asset protection features available under the law of many states in the United States. When the goal of the structure is comprehensive wealth preservation, such asset protection features can be just as important as the potential tax savings resulting from the structure. However, what is even less publicized is the fact that virtually all of the foregoing advantages are also available and often enhanced under the laws of several offshore jurisdictions. Thus, a wealth preservation planner seeking to achieve traditional wealth

74 Tex. Trust Code §112.035

75 First Northwestern Trust Co. v. IRS, 622 F.2d 387 (1990).

76 First Northwestern Trust Co. v. IRS, *infra* at 391.

77 First Northwestern Trust Co. v. IRS, *infra* at 392.

preservation goals with a family limited partnership and related entities can typically achieve those same goals, while achieving a better level of protection for family assets, through the use of offshore limited partnerships and limited liability companies.

As with domestic entities, the asset protection attributes of a family limited partnership derive from statutory as well as non-statutory sources. The limitations and restrictions found within the partnership agreement itself provide various tools that can be used to preserve partnership assets and the interest of the family members in the partnership. Otherwise attractive and valuable assets to a creditor are made less so when they are transferred to and held by a family limited partnership, particularly an offshore FLP. Assuming the partners have respected the family limited partnership as a separate and distinct legal entity separate from themselves, a creditor of one or more partners will be unable to reach partnership assets to satisfy its claim against any of its partners since the assets of the offshore partnership are owned by the partnership, not the individual partners.[78]

Moreover, should the creditor attempt to instead seize the debtor partners' interest in the family limited partnership, the "charging order" limitation found in several offshore limited partnership laws will likewise frustrate a creditor's efforts. The charging order limitations discussed in this paper are made available by statute in several offshore jurisdictions. They significantly limit the recourse available to a creditor seeking recourse against a judgment debtor's interest in a partnership. Generally speaking, the partnership interest cannot be seized or sold. Instead, the "charging" creditor becomes a mere assignee of the judgment debtor with respect to his partnership interest. Like many of the domestic counterparts, the partnership law of several offshore jurisdictions generally accords an assignee of a partnership interest little or no rights other than the right to receive distributions made with respect to the "charged" interest. These limitations on the rights of a partner's creditors enhance the value of the offshore family limited partnership as an important family wealth preservation vehicle.

Although relatively new to the offshore arena, the limited liability company ("LLC") is now also available in several offshore jurisdictions. Like its domestic counterpart, the offshore LLC is designed to bring together in a single business organization the best features of all other business forms. Properly structured, its owners obtain both a corporate styled liability shield for its members and the pass through tax benefits of a partnership. However, its asset protection benefits, especially when combined with a FLP, makes the offshore LLC a very valuable asset protection tool when structuring a family wealth preservation plan.

A. The "Charging Order" Limitation.

Like its domestic counterparts, the primary asset protection benefit of offshore charging order limitations found in several offshore jurisdictions has its roots in the English Partnership Act of 1890. The Act was adopted to prevent the disruption of partnership business and the consequent injustice done the other partners resulting from execution against partnership property. As Lord Justice Lindsey observed, the English Partnership Act of 1890 not intended to protect a debtor partner against claims of his judgment creditors where no legitimate interest of the partnership, or of the remaining or former partners is to be served. Thus, the charging order evolved as a way to divert the debtor's share of the partnership profits and surplus to his creditors without disrupting the ongoing partnership. The charging order operates, in effect, as a substitution for execution on a partner's interest in the limited partnership. Once charged, the judgment creditor has only the rights of an assignee of the partnership interest.

B. The Consequences of "Assignee" Status.

As with domestic LPs, a partner in an offshore LP typically may not freely transfer their interest in the entity to a third party without first obtaining the consent of the other partners of the partnership. If not prohibited outright, governing law typically provides that an attempt by a limited partner to transfer his or her interest in the partnership without obtaining the necessary consent will result in the transferee being relegated to "assignee" status. As in domestic law, an assignee of an offshore LP or LLC is relegated to a lower status of recognition in the entity, typically with little to no rights in the entity except to receive his or her pro rata share of distributions from the entity.

Under the law of most, if not all, offshore jurisdictions, a creditor that obtains a charging order against a partner's interest is treated as an "assignee" of that interest. As an assignee, a creditor has the right to receive distributions to which the debtor partner would have been entitled; however, the charging order does not entitle the creditor to become or to exercise any rights of a partner.[79] As an assignee of a partnership interest, the creditor may not become a limited partner unless all other partners consent,

78 Cayman Islands Partnership Law (1995) Revision, §23.(1).

79 Gibraltar Partnership Act (1984) §33(1).

something unlikely to occur.[80] The creditor cannot vote on partnership matters, inspect or copy partnership records, or even obtain from the general partner business and tax information regarding the affairs of the limited partnership that are usually available to limited partners as a matter of law.[81] Moreover, in a family limited partnership, the general partner will likely be an entity controlled by a family member sympathetic to the plight of the partner and family member whose interest in the partnership has been subjected to the creditor's charging order. Thus, it is unlikely that the general partner would elect to make cash distributions to partners that would entitle the creditor/assignee to a pro rata distribution.

C. The Offshore Family Limited Partnership.

The asset protection features found in the limited partnership statutes of several offshore jurisdictions provide the planner with multiple planning opportunities. Because these jurisdictions are, for the most part, present or former members of the British Commonwealth, the limited partnership law of these jurisdictions is often very similar to comparable law found in the United States. Hence, it is possible to draft a limited partnership agreement or operating agreement that will be familiar to U.S. practitioners and their clients. Moreover, many offshore jurisdictions have adopted modern limited partnership legislation that is specifically designed to address the legal and tax needs of United States citizens. Virtually any kind of provision typically drafted into a complex domestic limited partnership agreement can also be drafted into the agreement of an offshore limited partnership with virtually the same legal and tax results being achieved.

On the other hand, significant differences in the ownership structure will exist when the offshore limited partnership is formed for asset protection purposes. For example, the managing general partner is often a foreign limited liability company or international business corporation formed in a jurisdiction ***different*** from the jurisdiction in which the limited partnership is formed. Additionally, the offshore limited partnership can be formed in a jurisdiction that limits the creditor's remedies to a "charging order" against the limited partnership interest. If the general partner is a foreign limited liability company formed in Nevis, the general partner will enjoy the same charging order protection under the Nevis Limited Liability Company Ordinance of 1995 as the limited partnership. If an international trust owns the limited partnership interest, it is possible that a creditor may be forced to consider filing a lawsuit in three different jurisdictions, assuming the creditor has reason to believe it can reach trust assets in the first place.

Unlike uniform laws found in the United States, offshore jurisdictions do not have an organized effort to promote uniformity in legislation similar to those promulgated in the U.S. by the National Conference of Commissioners on Uniform State Laws. Nevertheless, it is not uncommon for offshore jurisdictions to adopt legislation modeled after the law of a fellow offshore jurisdiction. An excellent example is the charging order protection found in the acts of the Bahamas, Cayman Islands, and several other jurisdictions. In those jurisdictions, the language providing for the charging order protection is very similar.

An excellent example of a foreign jurisdiction with U.S. style limited partnerships with charging order protection is The Bahamas. The Bahamas have been a traditional favorite of Americans primarily because of its proximity to the United States. The Bahamas is a group of 700 islands stretching in a 600-mile arc which begins approximately 40 miles east of Palm Beach, Florida, and extends to just north of Haiti. The capital of the Bahamas is Nassau which is located on New Providence Islands, where approximately one-half of the people of the Bahamas live. The Bahamas are an independent member of the British Commonwealth of Nations.

The Bahamas are an excellent example of a jurisdiction that has good limited partnership legislation with favorable asset protection features. In the Bahamas, limited partnerships are governed by the Exempted Limited Partnership Act, 1995. However, to the extent that it is not inconsistent with the Limited Partnership Act, Section 3.(1) of the Limited Partnership Act incorporates the provisions of the general Partnership Act. It is in the Partnership Act that charging order protection is found.

Section 24.(1) of the Partnership Act specifically provides that *"a writ of execution shall not issue against any partnership property except on a judgment against the partnership itself."* In other words, a creditor holding a judgment against a partner may not seize partnership assets to satisfy a judgment against a partner. Thus, assets held inside the partnership itself are protected from claims against any of its partners.

The charging order limitation itself is found in Section 24.(2) of the Partnership Act which provides that the court may …

> "on the application by summons of any judgment creditor of a partner, make an order

80 Cayman Islands Partnership Law (1995) Revision, §73.(1)(a).

81 Bahamas Partnership Act §32.(1).

> changing that partner's interest thereon, and may by the same or a subsequent order appoint a receiver of that partner's share of profits (whether already declared or accruing), and of any other money which may be coming to him in respect to the partnership, and direct all accounts and inquiries, and give all other orders and directions which might have been directed to given if the charge has been made in favour of the judgment creditor by the partner, or which the circumstances of the case may require."

Section 24.(3) of the Partnership Act further provides that the other partner or partners are at liberty at any time to redeem the interest charged.

D. The Offshore Limited Liability Company.

Like a limited partnership, an offshore limited liability company can be used as an asset protection vehicle if it is supported by appropriate legislation. However, while several offshore jurisdictions have adopted LLC legislation, only a handful of offshore jurisdictions have incorporated the concept of charging order protection into their LLC legislation.

Many offshore LLC statutes provide that a judgment creditor has only the rights of an assignee of the LLC interest so charged.[82] For example, in Anguilla, an assignee of a member's limited liability company interest has no right to participate in the management of the business and affairs of a limited liability company except as provided in the LLC operating agreement and upon (a) the approval of all of the members of the LLC other than the member assigning his LLC interest or (b) compliance with any procedure provided for in the LLC operating agreement.[83]

Assets transferred to an LLC are also protected from member's creditors.[84] Members of an LLC are neither co-owners of nor have a transferable interest in, property of an LLC. Thus assets transferred to an LLC become the property of the LLC and not subject to the creditor claims of its individual members. Since a creditor's recourse against a member is limited to a charging order, assets transferred to an LLC can be effectively protected against levy and seizure by a creditor.

Of course, if the member is a U.S. citizen, resident, or is otherwise located in the United States, it is preferable, although not always necessary, that control of the offshore limited liability company remain offshore for all purposes. This can be particularly facilitated if the offshore limited liability company is wholly owned by an international trust that has exclusive control of the limited liability company for all purposes. In fact, many U.S. practitioners prefer a structure that provides for an international trust whose assets are held by an offshore limited liability company in one of the jurisdictions discussed below.

The Island of Nevis is considered by many to have the best LLC charging order protection. The Caribbean island of Nevis has been described by one commentator as the "Jewel of the Caribbean." Although the popularity of Nevis can be credited to its excellent asset protection law, its "U.S. style" corporate law has also made Nevis very popular with many U.S. practitioners. Nevis is located in the Leeward Islands in the Eastern Caribbean approximately 1200 miles southeast of Miami and 225 miles southeast of Puerto Rico. The island has a current population of 9,500. English is the official and commercial language.

In the view of many practitioners, Nevis is an example of a jurisdiction that has excellent asset protection features incorporated into its LLC legislation. Nevis adopted its Limited Liability Company Ordinance in 1995. The Act is modeled after the Delaware Limited Liability Company Act and is considered by many practitioners as the most modern offshore limited liability legislation of its kind.

Section 43 of the Nevis Limited Liability Company Ordinance, 1995, as amended, 1999, governs the right of a judgment creditor of a member. The Act provides that:

> "On application to a court of competent jurisdiction by any judgment creditor of a member of a limited liability company, the court may charge the member's interest with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the member's interest."

Unless otherwise provided in the operating agreement, a member's interest charged may be redeemed by either the other members of the LLC of the LLC

82 See, i.e., Anguilla Limited Liability Act, §47.(2).

83 Id., §48.(1).

84 This assumes that the transfer is not subject to attack as a fraudulent conveyance under state law should the transferring member already be insolvent.

itself.[85] If redeemed by one or more members, the redemption must be made with the personal assets of the redeeming members.[86] However, the LLC itself may use LLC assets to redeem the charged interest of a member provided such redemption is approved by either (a) the consent of the members, whose interest are not charged, if all members are responsible for the management of the LLC, or (b) by the managers, whose interest are not charged, if the managers are responsible for the management of the LLC.

Equally as important as the charging order limitation is Section 43.(3) of Nevis' Limited Liability Company Ordinance which specifically provides that the remedies provided by Section 43 of the Act "*shall be the sole remedies available to any creditor of a member's interest."*

E. Redomiciliation of a Domestic LP or LLC.

A typical U.S. client that is a candidate for offshore wealth preservation planning is likely to already own a significant interest in a domestic limited partnership that was initially established for estate planning purposes. Such a domestic partnership is typically controlled by a general partner that is a limited liability entity owned and controlled by the client and various members of his family. Often, assets to be protected are owned by the limited partnership.

Seeking the benefits of an offshore limited partnership does not necessarily require the liquidation of the domestic limited partnership. Doing so may have adverse tax consequences and could result in the transfers to the new FLP being challenged as a fraudulent transfer if one or more partners are subject to legal claims at the time. However, if the domestic limited partnership can be redomiciled to an offshore jurisdiction, most, if not all of the foregoing potential problems, can be avoided. An excellent example of offshore legislation that allows for redomiciliation is found in the Bahamas Limited Partnership Act is Section 21.(1) of the Act. The Act allows the registration in the Bahamas of an existing limited partnership formed under the laws of a jurisdiction other than the Bahamas. Thus, by way of example, a U.S. limited partnership, formed for either estate planning or asset protection purposes, can be redomiciled to the Bahamas by registering the partnership in the Bahamas as provided by the Exempted Limited Partnership Act. Section 21.(2) specifically provides that registration of a partnership under the circumstances shall not operate:

- to create a new legal entity;
- to affect the property previously acquired by or on behalf of the exempted limited partnership;
- to affect any act or thing done prior to such registration or the rights, powers, authorities, functions or obligations of the exempted limited partnership, any partner or any other person prior thereto;
- to render defective any legal proceedings by or against the exempted limited partnership or any partner or any other person and any legal proceedings that could have been continued or commenced by or against the exempted limited partnership or any partner or any other person before its registration hereunder may notwithstanding such registration be continued or commenced after such registration and in respect of which such Acts or laws of such other jurisdiction shall be of application.

This provision in Bahamian law is extremely useful as it allows the transfer to the Bahamas of a pre-existing partnership formed in the United States without the need of dissolving and liquidating the partnership. Doing so allows the partnership to continue as a legal entity, without interruption, from both a legal and tax standpoint. This is particularly important if the transfer is being undertaken at a time when one or more of the partners have encountered legal issues. By avoiding the dissolution and liquidation of the partnership, transfers that occurred to the partnership prior to the individual partner or partners encountering legal problems should not be subject to challenge as fraudulent transfers.

The Cayman Islands has similar legislation which is found in Section 21.(1) of the Exempted Limited Partnership Law (2001 Revision). The law allows the "re-registration" in Cayman of a limited partnership then existing outside of Cayman, after which the limited partnership will be deemed a Cayman limited partnership for all purposes after the date of "re-registration." However, the "re-registration of the limited partnership in Cayman will not be considered the creation of a new entity. Moreover, the law governing the limited partnership prior to re-registration shall continue to govern events that occur prior to redomiciliation to the Cayman Islands.

Some offshore jurisdictions similarly allow the redomiciliation of an LLC. For example, as in the Bahamas, Nevis law accommodates the redomiciliation into Nevis of a LLC formed under the laws of a jurisdiction other than Nevis so long as the law of *that* jurisdiction does not prevent such a redomiciliation. The redomiciliation process is commenced by filing an "Application to Transfer Domicile" with the Registrar

85 Nevis Ltd Liab Co Ordinance §43(2)

86 Id., §43(2)(b)

of Companies.[87] Once the LLC is redomiciled to Nevis pursuant to the Nevis Limited Liability Company Ordinance, the entity is treated for all purposes as the same entity that existed before the redomiciliation.[88]

F. Drafting Strategies.

U.S. practitioners are often surprised to learn that the law of several offshore jurisdictions easily accommodate U.S. style partnership agreements for LPs and operating agreements for LLCs.[89] Often, it is not uncommon for a practitioner to be able to use an agreement format that is familiar to the practitioner but is modified to conform to local law. Hence, virtually all planning strategies that can be incorporated into a domestic limited partnership agreement or operating agreement can likewise be incorporated into an offshore LP or LLC agreement including:

- **Protective Language in Governing Documents.** Although the applicable law of the offshore jurisdiction is important in identifying the remedies available to a creditor of a FLP partner or LLC member, the planner can and should incorporate protective language in the partnership agreement of an offshore FLP or operating agreement of an offshore LLC, similar to that usually drafted into its domestic counterpart and discussed above.
- **Offshore LLC as General Partner.** As with its domestic counterpart, enhanced asset protection is available by using a limited liability company as the general partner of a limited partnership. Before the advent of LLC's, it was customary to use a regular corporation or International Business Corporation ("IBC") as the general partner of an offshore limited partnership. This left the shares of the corporate general partner subject to seizure and execution by a creditor of the corporate general partner shareholder. However, if the general partners consisted of one or more LLC's organized in Nevis, the Marshall Islands, or other offshore jurisdiction with favorable legislation, a charging order against the general partner's LLC interest would be a creditor's sole recourse. Thus, while the general partner's LLC interest would be subject to the charging order, the general partner's interest would not be subject to seizure and potential corresponding loss of control of the limited partnership. From an asset protection standpoint, it is clear that a properly structured offshore LLC is usually the preferred entity to act as general partner of an offshore LP.
- **International Trust as Limited Partner.** A preferred but more sophisticated planning technique incorporates the use of an offshore asset protection trust in conjunction with the formation of an offshore limited partnership. The different variations of such a structure are discussed below in the section of this paper describing different strategies available when designing an offshore wealth preservation trust.

G. U.S. Tax Treatment of the Offshore LP and LLC.

The popularity of limited partnerships in the United States is due, in no small part, to the conduit or "flow-through" tax attributes of the entity for U.S. income tax purposes. A limited partnership is required to file an information tax return with the IRS but partnership income is reported pro rata by partners. Likewise, a domestic LLC with two or more members is typically treated as a partnership for U.S. tax purposes. However, while such treatment of domestic LPs and LLCs is automatic in the U.S., the exact opposite is true when dealing with offshore LPs and LLCs.

Great care must be undertaken when seeking conduit tax treatment in the U.S. for a foreign limited liability company or limited partnership. Under U.S. tax law, a foreign limited partnership or limited liability company will automatically be taxed as a corporation unless the entity affirmatively elects to be treated as a conduit entity for U.S. tax purposes. The election is made pursuant to the IRS "check-the-box" regulations[90] by timely filing Form 8832 with the Internal Revenue Service. If the proper and timely election is made, a foreign single member LLC may elect to be treated as a disregarded entity, or as a partnership if the LLC has more two or more members. A foreign limited partnership must likewise file an election to be treated as a partnership for U.S. tax purposes.

From a federal income tax reporting standpoint, assuming all required IRS elections for a foreign limited partnership are timely and correctly made:

- The offshore limited partnership will file a U.S. partnership return, Form 1065, on which it will report its worldwide income.

87 Nevis Ltd Liab Co Ordinance §66

88 Id., §70(1)

89 LLC's are known as limited duration companies in some offshore jurisdictions such as the Cayman Islands.

90 Treas. Regs. 301.7701-3.

- The partnership will also be required to file Form 8865 - Return of U.S. Persons with Respect to Certain Foreign Partnerships, which is typically filed with the partnership's Form 1065.
- If properly structured and maintained, the limited partnership interest should be eligible for valuation discounts for gift and estate tax purposes.

Significant adverse tax consequences or tax penalties are possible if elections or tax returns for offshore entities are not correctly prepared or timely filed. Therefore, a professional tax advisor experienced with the reporting requirements of offshore entities, should always be included as part of the client's planning and compliance team.

XI. INTEGRATING A FLP OR FLLC WITH A SELF-SETTLED TRUST TO ENHANCE A CLIENT'S ESTATE PLANNING STRATEGIES

This paper has attempted to show how the traditional FLP or FLLC, historically an estate planning vehicle, can also be used as a reasonably effective asset protection vehicle. However, while FLPs and FLLCs have historically been used successfully to obtain valuation discounts for federal gift and estate tax purposes, such strategy has recently been successfully challenged by the Internal Revenue Service in a series of successful attacks on the use of FLPs and FLLCs for estate planning purposes.

For years, the IRS has attempted to challenge the use of FLPs and FLLCs for estate planning purposes on a variety of theories. Until recently, except in those situations where the entity was not respected nor properly operated by the decedent, virtually all such challenges have heretofore been unsuccessful. However, in the recent tax court case of Estate of Strangi vs. Commissioner, discussed below, the Internal Revenue Service won an unexpected and incredibly significant challenge to the use of an FLP or FLLC to obtain valuation discounts for gift and estate tax purposes. In fact, the decision in Strangi suggests that any FLP or FLLC formed prior to the Strangi decision should be reevaluated in light of the strict requirements that would seem to have been imposed by the Fifth Circuit's affirmation of the Tax Court decision in Strangi. Nevertheless, both Strangi and other cases decided prior to that time provide practitioners valuable guidance on how to modify existing FLPs or FLLCs or organize new ones in the future.

As mentioned above and discussed in more detail in the tax section below, a typical international trust established by a U.S. person is intentionally drafted to qualify as a "grantor trust" for U.S. tax purposes. Failure to do so will result in a transfer to the trust being treated as (i) a taxable gift, and (ii) a taxable "sale or exchange" of the asset transferred to the trust. However, if established as a grantor trust, any assets held by the trust will be subject to estate tax upon the settlor's death. Thus, even if the primary goal of establishing the trust is the settlor's desire to achieve asset protection for the client and the client family and heirs, the client's planner should consider and integrate into the international trust structure estate planning strategies that will help reduce the estate tax burden of assets held within the trust upon the settlor's death. However, to enhance the likelihood that such planning will succeed, it is important, particularly in an offshore setting, that the resulting structure be established as part of an arm's length transaction with an independent trustee and minimal retained controls on the part of the settlor.

A. Estate of Strangi.

In the recent Tax Court case of Estate of Strangi vs. Commissioner[91], the estate sought to support valuation discounts, claimed on the decedent's estate tax return, for his interest in the Strangi Family Limited Partnership ("SFLP"). The decedent had transferred virtually all of his wealth to SFLP. After the transfers, Mr. Strangi owned a 99% limited partnership interest in SFLP and a 47% interest in the corporate general partner that owned a 1% general partnership interest in SFLP. The remaining 53% ownership of the corporate general partner was initially owned by the decedent's children although, apparently, a 0.25% interest in the corporate general partner was subsequently transferred to a charity, apparently under the belief that such action would help improve the asset protection attributes of the family limited partnership.

1. Section 2036(a)(1) Possession or Enjoyment Issues.

Section 2036(a) of the Internal Revenue Code provides that transferred assets of which the decedent retained *de facto* possession or control prior to death are included in the taxable estate of the decedent. Specifically, Section 2036(a)(1) provides that a decedent's estate shall include property over which the decedent retained the "possession or enjoyment" of property or the right of income from property. At the trial court level in Strangi, the Tax Court found that the decedent had retained "possession or enjoyment" of the property he transferred to the SFLP or the right to

91 Estate of Strangi vs. Commissioner, T.C. Memo 2003-145, (2003). The case was affirmed on appeal to the Fifth Circuit Court of Appeals. See footnote 97.

designate who would possess or enjoy it. Judge Mary Cohen found that the facts supported a finding that after the formation and funding of SFLP, the decedent, as a practical matter, retained the same relationship to his assets as before formation of the SFLP and its corporate general partner. In so finding, Judge Cohen remarked:

> ***"the crucial characteristic is that virtually nothing beyond formal title changed in decedent's relationship to his assets."***

The U.S. Fifth Circuit Court of Appeals upheld Judge Cowen's ruling in an opinion issued on July 15, 2005. In its ruling, the Fifth Circuit agreed with Judge Cohen's finding that the transfer of substantially all of the decedents assets into the FLP, leaving few assets available outside the FLP to pay the decedent's living expenses and post-mortem expenses, supported a finding of an implied agreement that allowed the decedent, Mr. Strangi, to retain *de facto* control and/or enjoyment of the transferred assets.[92]

One of the arguments made by the estate upon appeal was that the "bona fide sale" exception to Section 2036(a) was applicable in this case, even if Strangi had retained possession or enjoyment of the assets. In describing the "bona fide" sale exception, the Fifth Circuit noted that:

> "We think that the proper approach was set forth in Kimbell, in which we held that a sale is bona fide if, as an objective matter, it serves a 'substantial business [or] other non-tax purpose.' Id. at 267. As noted supra, Congress has foreclosed the possibility of determining the purpose of a given transaction based on finding as to the subjective motive of the transferor. Instead, the proper inquiry is whether the transfer in question was objectively lively to serve a substantial non-tax purpose. Thus, the finder of fact is charged with making an objective determination as to what, if any, non-tax business purposes the transfer was reasonably likely to serve at its inception. We review such a determination only for clear error."

The court analyzed multiple "non-tax" purposes offered by the estate for having formed the family limited partnership. Among those were the asset protection benefits of the SFLP. In Strangi, the alleged need for asset protection was justified as a result of the potential claim of a specific creditor. In analyzing the claim, the trial court discounted the asset protection purposes of the SFLP since the potential claim never materialized into an actual claim. However, in the opinion of this author and other commentators, the proper test should be whether the FLP or FLLC was formed for the legitimate goal of general asset protection. In fact, during oral argument before the Fifth Circuit, at least one justice on the court acknowledged that, in today's litigious society, asset protection strategies are a legitimate goal of an entrepreneur or other high net worth individual.

Unfortunately, the few cases that have addressed the issue of asset protection as a "non-tax" purpose for an FLP or FLLC have dealt with structures with less than ideal asset protection attributes. However, it is this author's belief that a properly structured family limited partnership or family limited liability company, drafted pursuant to ideal asset protection legislation found in states like Delaware and many offshore jurisdictions, will ultimately help support the argument that the asset protection goals of the FLP or FLLC were sufficiently achieved to support the proposition that the asset protection provided by such a structure is a legitimate "non-tax" purpose for forming the structure in the first place.

2. Section 2036(a)(2) Power to Designate Enjoyment.

Although the trial court in Strangi held that Section 2036(a)(1) require that the estate include the value of the transferred assets in the gross estate for federal estate tax purposes, the trial court went on to address the application of Section 2036(a)(2) to the Strangi case. Section 2036(a)(2) requires inclusion in the gross estate of transferred property with respect to which the decedent retained the right to designate the persons who shall possess or enjoy the property or its income.

The IRS argued in Strangi that the decedent had legally enforceable rights based upon the relevant agreements, not mere de facto control or influence over the family limited partnership. As a result, the decedent, the IRS argued, had the power and influence to designate persons who shall enjoy the property and income of the family limited partnership.

The estate disagreed with the government's contention that the decedent had retained unrestricted control of the FLP. In fact, as the estate pointed out, state law required that any power which the decedent might have retained would have been subject to state law fiduciary duties. By analogy, the estate pointed to the U.S. Supreme Court case in United States vs.

92 Estate of Strangi v. Commissioner, 417 F.3d 468 (5th Cir. July 15, 2005)

Byrum[93], where the IRS argued that by retaining voting control over the corporations in question, Mr. Byrum was in a position to select the corporate directors and thereby to control corporate dividend policy. That, in turn, gave Mr. Byrum the ability to regulate the flow of dividends. However, the U.S. Supreme Court noted in Byrum that "a majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interest at the expense of corporate interest" and the directors of a corporation "have a fiduciary duty to promote the interest of the corporation." Id. a 137-138. Such duties were legally enforceable by means of, for example, a derivative lawsuit.

However, in the Strangi case, the Tax Court rejected the analogy of the Strangi case to the facts in Byrum by pointing out, among other things, that the power to control the flow of income from the corporation by influencing the directors of the corporation nevertheless did not give Mr. Byrum the "right" to designate who was to enjoy income since such dividends were payable to a trust, established for the benefit of his children, which was controlled by an independent corporate trustee. Thus, as the U.S. Supreme Court noted in the Byrum case, even if Mr. Byrum had managed to flood the trust with dividends, he had no way of compelling the trustee to pay out or accumulate that income. Id. at 144. As a result, Mr. Byrum was found not to have retained the right to designate the persons who shall possess or enjoy property or its income, thus mandating inclusion in the estate under Section 2036(a)(2).

What these and other cases suggest is that, from both an estate planning standpoint and an asset protection standpoint, the ideal wealth preservation structure is one established at "arms-length" with an independent trustee and established for multiple purposes including estate planning, asset protection, investment diversification and long term preservation and holding of family assets.

B. Settlor as General Partner of a "Drop-Down" FLP.

A common planning technique popular with many practitioners incorporates the use of an offshore asset protection trust in conjunction with the formation of a domestic limited partnership. The client initially transfers the assets to be protected to a domestic limited partnership and retains both a general partnership interest and the limited partnership interest. Shortly thereafter, the client transfers the limited partnership interest to an irrevocable international trust. However, by retaining the general partnership interest, the client maintains managerial control over the assets transferred to the family limited partnership while protecting the limited partnership interest from the client's individual creditor claims. A similar strategy can be undertaken utilizing the enhanced benefits available through the use of an offshore LP or LLC. Nevertheless, whether using a domestic FLP or offshore FLP, such a strategy contemplates that the settlor will retain control of the FLP through the settlor's ownership and control of the general partner entity.

There are many reasons why a planner may design such a structure for the client. In many circumstances, such a structure may be the only strategy that the client feels comfortable with. In other situations, the assets held by the FLP, such as real estate developments or closely held business interests, may require the active involvement of the settlor in the day-to-day affairs of the entity. Thus, as in Strangi, the client retains control of the FLP even though some or all of the limited partnership interest has been transferred to an international trust. In any event, the foregoing strategy may be problematic if estate planning is one of the client's overall planning goals.

C. Consolidated Ownership and Control of FLP by Trust.

A more conservative approach, one preferred by this author, provides for both the general and limited partnership interest to be transferred to the international trust.[94] In such cases, the new general partner is typically a new entity, owned and controlled by the international trust. Control of the general partner entity, which in turn controls the entire limited partnership, is then vested in managers appointed and controlled by the offshore trustee, thus striping the settlor of any direct or indirect control over partnership assets. The resulting structure is one where the ownership and control of the FLP has been totally integrated and combined with the international trust.

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93 United States vs. Byrum, 408 U.S. 125 (1972)

94 Before adopting such a strategy, the transfer must be planned in a way that does not result in the inadvertent termination of the FLP for tax purposes. A typical asset protection trust is usually drafted to qualify as a tax neutral "grantor trust," resulting in the individual grantor of the trust being treated as the owner of the trust assets for income and estate tax purposes. Thus, if the settlor-beneficiary of the trust is, in an individual capacity, also serving as general partner of a FLP to be transferred to an international trust, a new general partner, one that will be recognized as a separate "person" for tax purposes, must be designated as general partner of the FLP.

The resulting consolidated wealth preservation trust provides significantly enhanced estate planning benefits and asset protection to the client.

As discussed in the section of this paper on "*Redomiciliation of a Domestic LP or LLC,"* if the client already has a domestic FLP or LLC, particularly one established for estate planning purposes, it is possible to redomicile the entire entity to an offshore jurisdiction that provides enhanced protection for the interest of the partners or members in the entity. Even if part of the ownership interest of the FLP or LLC is already held by other family members, such as domestic trusts established for the benefit of the client's children and grandchildren, redomiciliation can still be achieved. The client's entire remaining interest in the structure, either before or after redomiciliation, can then be transferred to an international trust established by the client.

The advantages of such a strategy are significant. From an estate planning standpoint, such a structure, if properly designed, implemented and operated, avoids the estate planning problems so often faced by taxpayers in cases such as Strangi and others. Of course, the operative requirements are a properly designed, implemented and operated structure drafted with estate planning goals in mind. If done correctly, such a structure will significantly enhance the discounts valuations available to the client, for estate planning purposes, upon his or her death. From an asset protection standpoint, such a structure, again assuming it is properly designed, implemented and operated, will also optimize the asset protection benefits available to the client.

XII. USE OF ENTITIES AND TRUSTS FOR PREMARITAL PLANNING IN LIEU OF A PREMARITAL AGREEMENT

The same strategies that can be used to protect wealth from creditor claims can often be used to protect premarital wealth. This section of the paper will focus on the proper use of entities and/or domestic and international trusts for lawful premarital wealth preservation strategy.

Virtually all states provide a comprehensive mechanism by which prospective spouses can enter into a premarital agreement. Unfortunately, as discussed below, the requirements of state laws governing such agreements are many and narrowly construed. Moreover, there is no assurance that parties about to marry will be able to reach an agreement in principal, much less an agreement that complies with the applicable law. In many cases, the issue of a premarital agreement is never broached. This leaves the party with significant assets at risk that assets will become commingled or otherwise claimed to be part of the marital property estate should the marriage later dissolve. Although there are many benefits with having the parties entering into a valid and binding premarital agreement, a party entering a marriage with substantial assets can, in most cases, nevertheless take significant steps to help isolate and protect the separate property status of assets prior to marriage and to protect those assets, if so desired, from the election available under the law of states which allows a surviving spouse to "take against" a decedent's will.

A. Marital Law Property - General Principals.

The marital status of property owned by an individual is governed by state law. Generally speaking, states fall into two categories. Most states, except those classified as "community property" states, are known as "equitable distribution" states, although they are also sometimes called "common law" states. There is a significant difference in the consequences of property ownership in "community property" versus "common law" or "equitable distribution" states. Those differences include the disposition of property upon a subsequent divorce of the parties and the distribution of property upon the death of one of the spouses.

1. Community Property.

Community property law derives its roots from Old Spanish marital property law. The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Generally speaking, community property is deemed to be all property acquired by the married couple during marriage. The status of the property as community property is ***not*** dependent on which party acquired the property or earned it. Any property purchased or otherwise acquired by a married couple with community property funds is also deemed to be community property. Moreover, all debts incurred by a married couple, regardless of which spouse incurred the debt, is deemed to be community debt.

Upon death or divorce, as a general rule, community property is deemed to be owned equally by both the husband and the wife. However, in a divorce setting, a judge in a community property state typically has the authority to allocate and award community property on a ratio other than 50-50 if such an allocation and award is deemed appropriate under the circumstances, particularly if one spouse has significantly greater earning capacity than the other.

A typical example of community property law can be found in Texas where, although based upon the Texas Constitution, it is codified in Chapter 3 of the Texas Family Code. Chapter 3 defines separate versus

community property law and all related consequences. Specifically, Section 3.001 of the Texas Family Code provides that a spouse's separate property consist of:

(a) the property owned or claimed by the spouse before marriage;
(b) the property acquired by the spouse during marriage by gift, devise, or descent; and
(c) the recovery for personal injury sustained by the spouse during marriage, except any recovery for loss of earning capacity during marriage.

Community property is defined by Section 3.002 as property, other than separate property, acquired by either spouse during marriage. Property possessed by either spouse during or on dissolution of marriage is presumed to be community property. TEX. FAM. CODE ANN. §3.003 (1998). A subscribed and acknowledged schedule of a spouse's separate property may be recorded in the deed records of the county in which the parties, or one of them, reside and in the county or counties in which real property is located. TEX. FAM. CODE ANN. §3.004 (1998).

Not all community property states have identical law. One aspect of Texas law that is different is the treatment of income from separate property. Although it comes as a surprise to prospective spouses and many attorneys, Texas law is clear that income derived from separate property is community property. Arnold v. Leonard, 273 S.W. 799 (Tex. 1925). Therefore, ordinary dividends received from separate property corporate stock, or a distribution from separate property partnership interest are community property. Harris v. Harris, 765 S.W. 2d 798, 802 (Tex. App. – Houston [14th District] 1989 (writ den'd).

2. Equitable Distribution States.

Most states in this country are classified as "equitable distribution" or "common law" states. In an equitable distribution state, property acquired during a marriage typically belongs to the person who earned it or in whose name title of the property is taken. However, upon divorce, the property will be divided between the spouses in a "fair and equitable" manner, hence the term "equitable distribution." Property acquired by either spouse during marriage is typically deemed to be "marital property" and subject to division to the court. In most equitable distribution states, the concept of "separate property" is similar to that found in community states, and recognized by the law and the courts. Therefore, in most cases, even in an equitable distribution state, separate property will not be subject to division upon divorce. However, not all states follow this pattern. Some states will thus take separate property into consideration when dividing property in an equitable distribution state. Moreover, even those equitable distribution states that recognize the status of separate property as such often find that the property has been transformed into "marital property," or will often respect property as "separate property" of one spouse yet expressly take into consideration the value of the separate property in making an "equitable division" of the divorcing party's marital property.

A significant minority of states follow the "all property" concept of property division in a divorce or death situation. In such so-called "all property" model states, the courts view a marriage as a merging of two separate estates resulting in the creation of one single estate. Thus, upon a divorce or even death, all such "merged" property is subject to equitable division by the court. Thus, in such "all property" states, a party that brings a significant amount of separate property to the marriage will suddenly find that such separate property has been combined with the marital property of the spouse to arrive at the total amount of property that is divisible by a divorce court. To put it in a cynical view, a person with significant separate property who marries someone with little or no property of their own essentially runs the risk of losing all or a portion of the separate property that belongs to him or her upon marriage. However, even in "all property" states, the courts will generally not attempt to divide property that is owned by "a third party." Thus, even in "all property" states, careful premarital planning can enable an individual to protect his or her separate property from the ravages of divorce through careful planning ***prior*** to marriage.

An excellent analysis of those states that follow the "dual-classification" of property and those who follow the "all property" concept was discussed and identified, by state, in an excellent article by Brent R. Turner, "Rehabilitative Alimony Reconsidered: The 'Second Wave' of Spousal Support Reform," 10 Divorced Litig. 185 (1998), wherein Mr. Turner analyzed the marital property law of 51 American jurisdictions and classified 35 as "dual-classification" states, including 28 equitable distribution states and 7 community property states, and 16 states as "all property" states.

B. Premarital Agreements.

In 1983, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Premarital Agreement Act (UPAA) which has been adopted by 26 states, including Texas and California. On April 17, 1997, the Act was reorganized under Title 1 of the Texas Family Code.

Section 6 of the UPAA governs the enforceability of a premarital agreement. The law provides and exhaustive checklist of requirements that must be met if a premarital agreement is to be enforced as a matter of law. Specifically, Section 6 of the UPAA provides:

(a) A premarital agreement is not enforceable if the party against whom enforcement is requested proves that:

(1) the party did not sign the agreement voluntarily; or
(2) the agreement was unconscionable when it was signed and, before execution of the agreement, that party:

(A) was not provided a fair and reasonable disclosure of the property or financial obligations of the other party;
(B) did not voluntarily and expressly waive, in writing, any right to disclosure of the property or financial obligations of the other party beyond the disclosure provided; and
(C) did not have, or reasonably could not have had, an adequate knowledge of the property or financial obligations of the other party.

(b) An issue of unconscionability of a premarital agreement shall be decided by the Court as a matter of law.

The requirements of the UPAA are strictly construed in most states. Therefore, to be enforceable under state law, a premarital agreement must strictly comply with the requirements of the UPAA as enacted in that state. In fact, the requirements of the Code are so strict that common practice contemplates that each party's legal counsel will execute the agreement to further evidence the informed consent of the parties entering into the agreement. The many requirements of the UPAA nevertheless make premarital agreements subject to attack well after they are executed.

C. Surviving Spouse Elective Share Upon Death of Married Person in Equitable Distribution States.

Most states in the United States allow the surviving spouse of a decedent to take an "elective share" of a decedent's estate. Such an election has the effect of allowing the surviving spouse the right to either (a) accept that part of the decedent's estate that has been left to the surviving spouse by the deceased spouse, or (b) elect to "take against the will" of the deceased spouse by, instead, electing to take a larger share of the decedent's estate as provided by statute. The obvious intent of such elective share statutes is to insure that the surviving spouse receives his or her "fair share" of the decedent's estate, particularly in long-term marriages. There is nevertheless a very broad range of statutes and results that can be found throughout the United States.

In an effort to bring national uniformity to the concept, the National Conference of Commissioners on Uniform State Laws has adopted and continues to update the Uniform Probate Code as a nationally recommended model for the improvement of state law relating to the succession of property at an owner's death, as controlled by will, and intestacy statute, and the probate process.

The general rule under the Uniform Probate Code, which has been enacted by multiple jurisdictions, is that a surviving spouse can elect to take under the decedent's will or to take a certain percentage against it. An example of a statute based upon the Uniform Probate Code can be found in Hawaii. The Hawaiian statute gives a surviving spouse the right to take an elective-share percentage amount, determined by a statutorily defined schedule, of the decedent's "augmented estate." *HRS §560:2-202 (2003).* The elective share percentage amount is determined by the length of time that the decedent and the surviving spouse were married. The amount starts at 3% for less than a year of marriage and increases by 3% each year until the 11th anniversary when it jumps by 4% per year until the 15th anniversary when it hits the cap of 50% of the augmented estate. This variable scale is conceivably included to protect against the inequity of a short-term spouse gaining a windfall through the elective share.

Perhaps the most important term set forth and described in the Hawaii statute is that of the "augmented estate." Its value consists of:

(a) the sum of the values of all property, whether real or personal; movable or immovable, tangible or intangible, wherever situated, that constitutes the decedent's net probate estate,
(b) the decedent's non-probate transfers to others,
(c) the decedent's non-probate transfers to the surviving spouse, and
(d) the surviving spouse's non-probate transfers to others. *HRS §560:2-203 (2003).*

This value is reduced by funeral and administration expenses, homestead and family allowances, enforceable claims against the estate, and exempt property. *HRS §560:2-204 (2003).* The Code goes on to elaborate on some of the augmented estate elements put forth in §560:2-203. Most poignantly, §560:2-205 further defines the types of non-probate transfers that are included in the value of the augmented estate. In regards to trusts, it states that the augmented estate includes any irrevocable transfer, made during marriage,

> …in which the decedent retained the right to the possession or enjoyment of, or to the income from, the property if and to the extent the decedent's right terminated at or continued beyond the decedent's death. The amount included is the value of the fraction of the property to which the decedent's right related, to the extent the fraction of the property passed outside probate to or for the benefit of any person other that the decedent's estate or surviving spouse.

HRS §560:2-205(2)(A) (2003). This and the rest of the expansive definition of the augmented estate put forth by the provisions of Rule 2-205 includes any assets which the decedent retained any type of control over or enjoyed any benefits from. However, the crux of this statutory language is the last phrase: "to the extent the fraction of the property passed outside probate to or for the benefit of any person other than the decedent's estate or surviving spouse." Unfortunately, this statute has not been interpreted or tested by Hawaiian courts but it seems to include in the augmented estate any transfers for the benefit of anyone. In fact, this specific provision has only been cited by one case and it was only referenced, not explained. *In re Estate of Searl,* 72 Haw. 222 (1991).

While generally the decedent's intent is given great weight in interpreting a will, almost all common-law states consider spousal disinheritance one of the few instances in which that intent may be modified. Common-law states generally recognize that, regardless of the decedent's intent, the surviving spouse has an interest in the decedent's estate. *19 Ohio N.U.L. Rev. 951 at 954 (1993).* There has been some scholarly concern expressed that the force of the elective sharing statutes gives too much power to the surviving spouse. *2 Conn. L. Rev. 513, 543-45 (1970).* Furthermore, there has been concern that the effect of the strong elective sharing statutes in the context of short-term marriages has somewhat undermined the public policy purpose of ensuring that a long-term spouse is provided for by the decedent's estate rather than by society. However, there is also support for the position that the duty to support arises at marriage regardless of the length of the marriage. *76 Iowa L. Rev. 223, 238 (1991).*

The main differences among the states relate to the definition of the decedent's estate that is available to spousal elective sharing and the percentage of that estate that the surviving spouse has a right to, either one half, one third, or a variable scale like that provided in the Uniform Probate Code. Other idiosyncrasies include limiting the surviving spouse's right to the elective share to a life estate, limiting the use of the elective share to a period of time, and varying the percentage by the number of children of the marriage.

There are sixteen states that utilize the augmented estate concept: Alaska, Arizona, Colorado, Florida, Hawaii, Idaho, Maine, Michigan, Minnesota, Montana, Nebraska, New Mexico, North Dakota, South Carolina, South Dakota, and Utah. In states that retain non-augmented estate elective share statutes, courts use various equitable rules in a case-by-case inquiry into the decedent's use of various will substitutes: under this approach property transferred out of the estate is considered part of the probate estate if the conveyance is "illusory," or if the decedent "intended to defraud" the surviving spouse of his or her marital right in the estate, or if the decedent lacked "present donative intent" with respect to the transfer. *In re Amundson,* 621 N.W.2d 882, at 889 (2001).

The National Conference of Commissioners on Uniform State Laws designed the revised Uniform Probate Code to achieve several goals, one of which was the protection of a surviving spouse's right to a "fair share" of the decedent's estate. *Id.* at 886. Simply stated, the right of a spouse to take an elective share was created to prevent disinheritance of the surviving spouse, *Estate of Karnen,* 607 N.W.2d 32, at 36 (2000)., and the concept of the augmented estate acts to thwart efforts to evade elective share through the use of testamentary substitutes.

Looking to analogous situations dealing with creditors, at least one state, Alaska, enacted statutes in 1997 that seeks to protect irrevocable trusts, and possibly other types, from vulnerability. *Alaska Stat. §34.40.110(a)-(b) (2004).* Furthermore, Alaska extends this ability to other jurisdictions by providing that the protection afforded by §34.40.110 would be honored as applied to assets from foreign-out of state-trusts so long as the trust situs is moved to Alaska. *Alaska Stat. §13.36.043 (2004).* The settlor of the trust cannot retain unfettered control over the trust and enjoy the protection afforded by the statutes but, via the use of a willing trustee, the settlor may still

maintain some discretion to use or possess the assets. *48 Drake L. Rev. 769, at 783 (2000).*

Soon after Alaska passed its asset protection legislation, the state of Delaware enacted the "Qualified Dispositions in Trust Act." *12 Del. C. §§3570-3576 (1998).* Similar to the Alaska law, the QDTA provides settlors with extensive creditor protection while allowing them to retain a discretionary beneficial interest in the trust. *49 Syracuse L. Rev. 1253, at 1271 (1999).* The Delaware Act contemplates the use of a Delaware trust to allow a married person the ability to protect property that might otherwise be subject to the right of a surviving spouse to elect to take a larger percentage of an estate in "augmented" property states.

D. The Entity Theory.

One of the most important and useful tools in premarital planning is a concept developed in the formulation of corporate and partnership law throughout the twentieth century. The National Conference of Commissioners on Uniform State Laws significantly updated the Uniform Partnership Act in 1994, thereby replacing the original Act adopted in 1914. One of the unanswered issues left open by the 1914 Act was the conflict in partnership law over the nature of the organization. Specifically, the Act failed to address the issue of whether the partnership should be considered merely an "aggregation" of individuals or should it be regarded as an entity by itself. These issues were put to rest in the 1994 UPA which clearly adopted the "entity theory" of partnership law. Section 201 of the UPA (1994) specifically provides that a "partnership is an entity." The recognition of the "entity theory" in determining the marital property rights of spouses plays an important role in premarital planning for an individual with significant separate property to be protected. Under the entity theory, the spouse/shareholder/partner owns an interest in the entity, not in the individual assets of the entity.

1. Limited Partnerships.

Under the entity theory of partnership in the Uniform Partnership Act, partnership property is owned by the partnership entity, not the individual partners.[95] A partner's right in specific partnership property are wholly subordinate to the rights of the partnership entity as owner of the property. The partner may possess the property only for partnership purposes. Partnership property is therefore neither separate nor community in character.[96] . The only partnership property right the partner has which is subject to community, marital, or separate property characterization is his or her ***interest*** in the partnership. That is the partner's right to receive his or her share of the partnership profits and surplus.[97] However, distributions of the partner's share of profits and surplus (income) received during marriage might be classified as marital or community property even if the partner's interest in the partnership is separate property.[98] Similar concepts apply in the corporate context.

The concept of the entity theory provides significant planning opportunities in a premarital setting. The marital property status of a partnership or corporate interest will depend on the marital property status of the property contributed to the entity in exchange for the interest obtained. Thus, a spouse that transfers separate property to an entity prior to marriage will preserve the separate property status of the property by converting it to an interest in an entity such as a corporation, partnership, or limited liability company. Thereafter, under the entity theory, the income earned by those assets will constitute income of the entity, not income of the individual. As such, the income earned inside the entity will not have marital or separate property status. Thus, both the underlying property transferred to the entity in addition to the income earned by the property inside the entity will be protected as separate property of the contributing spouse.

2. Characterization of Partnership Income.

An area of potential confusion and inequity is associated with the treatment of income earned by a partnership. Part of the confusion stems from the federal income tax treatment of partnership income for federal income tax proposes. As can be seen below, it is possible that a spouse will be required to pay federal income tax on income that he or she does not have a legal right to. Hence, the potential inequity.

(a) Characterization for Income Tax Purposes.

For federal income tax purposes, unless a limited partnership has elected to be treated as a corporation, the limited partnership will be treated as a "conduit" for income tax purposes. In other words, the partnership itself will not pay any tax. The tax will be paid be the partners of the partnership. Typically, the partnership will file an annual income partnership return with the Internal Revenue Service reflecting its

95 Marshall v. Marshall, 735 S.W. 2d 587, 593-594 (Tex. App. – Dallas 1987, writ ref'd n.r.e.).

96 Marshall at 594.

97 Marshall at 594; McKnight v. McKnight, 543 S.W. 2d 863, 867-868 (Tex. 1976).

98 Arnold, Id.

taxable income and related deductions. In that return, the partnership will then report the prorata share of taxable income to all of the partners. Each partner is provided a Form K-1 which reflects the amount of income which each individual partner is required to report on their individual income tax return.

It is important to note that each partner is required to report their prorata share of income or loss, ***regardless of whether that income was distributed to the partners or not.*** Thus, by way of example, if a partner's share of partnership income was $100,000, that partner is required to report that $100,000 income on his personal tax return even if the partnership did not distribute a dime of the money to the partner. This can result in significant inequities on a joint tax return if the tax is paid with community property funds.

(b) Actual Distributions of Partnership Income.

As discussed above, income from separate property, with very limited exceptions, may be classified as marital property. Therefore, under the entity theory outlined in Marshall v. Marshall, 735 S.W.2d at 594, partnership income actually distributed by a partnership to a partner will likely be classified as community or marital property in the hands of the recipient.

(c) Undistributed Partnership Income.

Again, under the entity theory of the Uniform Partnership Act, and as outlined in Marshall v. Marshall, income earned by the partnership is property of the partnership, not the partners. Thus, as long as partnership income is not distributed, undistributed income will constitute partnership property, and not part of the separate or community property of any underlying partner until and unless the income is distributed to the partners.

The treatment of partnership income can result in significant inequities. As long as it is not distributed, income earned by the partnership does not become part of the marital property estate of the partner. However, because of the different treatment of that income for federal income tax purposes, the partner, whether or not married, must report his or her share of the income from the partnership on his individual income tax return. If married, this "phantom income" will be treated as community property by the Internal Revenue Service. Thus, if a joint tax return in filed, the "non-partner" spouse will effectively be required to report her prorata share of income from the partnership, for tax purposes, despite not having a marital property interest in the income of the partnership under Texas law. If the income is not distributed prior to divorce, the net affect is a depletion of the community property estate as a result of the community estate having to pay income tax on the phantom partnership income that the community estate has never received.

3. Community Right to Reimbursement.

To prevent abuse, community property states long ago development a significant line of decisions which holds that the "community" is entitled to reimbursement for time, toil, and talent spend by one spouse for the benefit and enhancement of his or her separate property interest.[99] While the law contemplates that a spouse may expend a reasonable amount of talent or labor in the management and preservation of his or her separate property without impressing a community character upon it, the "community" is entitled to adequate compensation for significant services and talent devoted by the spouse with respect to his or her separate property. If the community does not receive compensation under those circumstances, the community property estate is entitled to "reimbursement" by the spouse that devoted his or her efforts towards the enhancement of the value of his or her separate property. Therefore, when relying on the entity theory to protect the separate property status of a spouse's property, great care should be undertaken to insure that the entity adequately compensates the separate property owner for time and effort expended in maintaining and enhancing the value of his or her separate property.

E. Classification of Trust.

The concept of a trust provides for the "beneficial" ownership of trust assets to be separated from legal title. Hence, the trustee will typically hold "legal title" to the property whereas the beneficiary will have only a beneficial interest in the trust. Moreover, if the trust is a discretionary trust, the trustee will typically have the sole discretion to determine the extent to which the beneficiary will enjoy the beneficial interest in the trust. In any event, whether the trust was created prior to marriage or after marriage, an individual beneficiary, unless he or she is also the trustee, will not have legal title to the trust or trust assets. As such, it is not part of the marital estate.

1. Trusts Created Prior to Marriage.

Whether a beneficial interest in a trust is separate property or community or marital property is based upon the "inception of title" rule. Hence, a beneficial interest in the trust owned or acquired prior to marriage shall be the separate property of that beneficiary in most states.

[99] Jensen v. Jensen, 665 S.W. 2d 107, 109 (Tex. 1984).

2. Distributions of Trust Income.

Income distributions by a self-settled trust to a beneficiary will constitute community property unless its classification has somehow been altered pursuant to a prenuptial agreement.[100] The fact that the beneficiary's interest in the trust is deemed to be "separate property" does not affect the classification of distributions of income from that trust. Once distributed, those income distributions become community or marital property in the hands of the beneficiary. However, if the trust making the distribution is one created by a third party settlor, there is case authority to support the proposition that the income distributions remain the separate property of the beneficiary.

3. Undistributed Income.

Following a principal similar to the "entity theory," the courts have treated undistributed trust income as neither community or marital property nor the separate property of the beneficiary. In one case, where the husband did not have the right to force a distribution of income, the court held that such accumulated but undistributed income was the separate property of the husband.[101] If income distributions are discretionary on the part of the trustee, accumulated but undistributed income will most likely be treated as part of the trust estate or the separate property of the beneficiary.[102]

A different result will occur if the beneficiary has an absolute right to receive the income, or is in control of the income, or has merely elected to allow income, which he had the right to receive, to remain within the trust. In those cases, accumulated income in the trust, to the extent that it is under the "control" of the beneficiary, will likely be treated as community or marital property and, therefore, subject to division upon divorce.[103]

4. Sham Trusts.

As with any trust, it is important that all of the requisite formalities associated with the trust be recognized by all parties, particularly the settlor/beneficiary of the trust, in order to protect the trust and its assets. Even those states that recognize assets of a trust as being assets owned a "third party," will not hesitate in including the assets of the trust in a marital division if it is shown that the trust is nothing more than the alter ego of the settlor beneficiary. The more control that an individual may have over a trust, the more likely that a court will not hesitate ignoring the existence of the trust for any purpose, whether it be asset protection or the division of marital property. Thus, while the law of domestic jurisdictions such as Delaware and Alaska, as well as most offshore jurisdictions, allow the settlor to have varying degrees of control over the trust and its assets, it is this author's opinion that any amount of significant control on the part of a settlor/beneficiary will jeopardize the settlor's ultimate goal for establishing the trust in the first place.

F. Premarital Planning Strategies for High Net Worth Clients.

An offshore wealth preservation trust, particularly when combined with a "drop-down" estate planning vehicle such as a family limited partnership or family limited liability company, is an ideal legal structure to segregate and preserve the premarital assets, particularly liquid assets, of a high net worth individual or professional with significant assets at risk. This is particularly true in equitable distribution states where separate property can often be included in the menu of assets to be "equitably distributed" upon divorce or subjected to the election of the surviving spouse to "take against" the decedent's last will and testament.

Theoretically, a domestic self-settled trust, now available in eight states, could possibly provide the same level of premarital protection as an offshore wealth preservation trust. However, as discussed elsewhere in this paper, domestic self-settled trusts are relevantly new concepts in the United States. Because of their newness, their effectiveness is relatively untested, particularly when established by a settlor who is not a resident of one of the eight states that offers such trusts. Thus, assuming the assets at risk justify the cost, an offshore wealth preservation trust is much better suited for the client's premarital planning. Moreover, since many states recognize both the "inception of title" rule for trusts and the "entity" theory for limited partnerships and similar entities, combining the two in a single consolidated structure, particularly when done using entities organized offshore, can provide a double level of legal insulation of assets transferred to the wealth preservation structure prior to marriage. The fact that the ownership of the assets held by the offshore wealth preservation trust is governed by foreign law further helps to insulate the assets of the trust from the claims of future spouses, whether at death or at divorce.

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101 Ridgell v. Ridgell, 960 S.W.2d at 148.

101 In the Matter of the Marriage of Burns, 573 S.W.2d, 555 at 557.

102 Lemke v. Lemke, 929 S.W.2d, 662, 664 (Tex. App.–Fort Worth, 1996, writ den'd).

103 In the Matter of the Marriage of Long, 542 S.W.2d, 712, 718 (Tex. Civ. App.–Texarkana, 1976, no writ).

The same strategies that are discussed herein for premarital planning purposes can often be used for post-marital planning, particularly in community property states. If the client's assets are clearly separate property and not subject to a then existing interest of the client's spouse, those assets can theoretically be transferred into the same offshore wealth preservation structure that is recommended for premarital planning purposes. Nevertheless, great care should be taken by the professional planner when undertaking such a post-marital planning strategy, particularly in equitable distribution states. The risk arises from the possible argument by the objecting spouse that a post-marital transfer of separate property violates rights that may have already accrued to the objecting spouse by virtue of the marriage. This argument is particularly problematic in those states described in this paper as "augmented estate" jurisdictions. In any event, regardless of the individual's state of residence, great care and analysis should be performed by the professional advisor before undertaking post-marital wealth preservation planning using the strategies and structures described in this paper.

G. Summary.

Regrettably, the sacrament of marriage is not as sacred as it once was. It is not uncommon to have a client that is working on his or her third marriage. If the client has begun to accumulate wealth, notwithstanding prior divorces, future marriages can continue to be problematic when the issue of prenuptial agreements is first discussed. As a result of the uncertainties of our judicial system and domestic marital property laws, professional advisors should consider the benefits associated with the implementation of a domestic or offshore wealth preservation strategy prior to marriage or, in appropriate cases, even after marriage. It not only avoids the often unpleasant task of asking a future spouse to sign a pre-marital agreement, it also prevents the need to make the vast financial disclosure that is required under most state laws to make such agreements enforceable. In fact, the future spouse does not even need to know about the existence of the premarital wealth preservation structure. Moreover, in many cases, it may be possible to protect separate property assets after the consummation of the marriage, although great care must be taken when implementing any type of post marital planning that does not involve the express consent of the non-participating spouse. Whether done prior to marriage or done properly after marriage, upon a divorce, the assets in a properly implemented structure can be protected from the claims of a divorcing or surviving spouse, particularly with an offshore structure where the assets are safely and legally outside the jurisdiction of a divorce court.

While such structures can provide a multitude of benefits, they should only be used under specific circumstances. Both the client and the client's advisor must be fully knowledgeable of the issues involved with the implementation of such a wealth preservation structure for the client, especially when done after the client has married. Use of a wealth preservation structure in an attempt to or as part of a scheme to defraud an existing spouse will, in most cases, fail outright, and in the worst case, result in potential civil liability to the client and the client's attorney. Nevertheless, with careful planning, a domestic or offshore wealth preservation structure can provide the client with significant protection against the uncertainties associated with a division of assets upon a divorce or death.

XIII. THE INTERNATIONAL WEALTH PRESERVATION TRUST

The inherent problems associated with domestic trusts, aggravated by outrageous jury judgments and, in some cases, result oriented courts, have prompted many individuals to seek asset preservation strategies beyond the borders of the United States. Although transfers of assets offshore have traditionally been associated with illegal attempts to evade tax or conceal assets, international trusts have become generally acceptable throughout the world as a legitimate means to deal with the many uncertainties in today's world that can result in threats to wealth.

A. Benefits of an International Trust.

There are numerous benefits available to using an international trust as part of a legitimate asset preservation plan for a client. This is an area of the law that is constantly changing as a result of (i) modernized and progressive asset protection trust legislation enacted by multiple offshore jurisdictions and (ii) constantly changing U.S. laws and court decisions which make it critical that any offshore planning be fully compliant with applicable U.S. tax law and a plethora of federal laws which might be applicable to any proposed transaction. Failure to take into account all possible issues could quickly result in the client not benefiting from the many advantages of an international wealth preservation trust. Nevertheless, the following is a brief summary of the advantages of using an international wealth preservation trust for the high net worth client or family.

1. Self-Settled Trust Permissible.

Most offshore jurisdictions will permit a settlor to establish a self-settled trust wherein the settlor retains beneficial enjoyment or control over the trust assets and/or the administration of the trust, something which is typically not possible in the U.S. Although it is typically a better planning strategy to avoid any unnecessary control on the part of a settlor, the fact that the settlor has retained a beneficial interest in the trust or has a right to exercise certain defined powers in the trust has, in many jurisdictions, been expressly permitted by statute.

2. Chilling Effect of International Trust.

A potential creditor and his/her attorney will not welcome the news that a debtor's assets have been sheltered in a foreign trust. A foreign trust constitutes an additional hurdle which the creditor will have to overcome. The mere logistical obstacles presented by the distance of some of these offshore jurisdictions is enough to drive plaintiffs to the settlement table.

3. Non-recognition of Foreign Judgments.

Even if a Plaintiff were to obtain a judgment against a Defendant, most offshore jurisdictions will not recognize a foreign judgment. Under the law of most offshore jurisdictions, a creditor must file suit in the jurisdiction in which the trust is located if a creditor intends to enforce a judgment against assets of the trust. Plaintiffs and their attorneys are sometimes surprised to learn that contingency fee arrangements are unique to the United States and, in some offshore jurisdictions, outright illegal.

4. Confidentiality.

A legitimate wealth preservation plan contemplates that a debtor will be prepared to make full and complete disclosure, if compelled to do so, regarding the transfers that were made into an international trust. Secrecy should never be a necessary element of a legitimate wealth preservation plan. Nevertheless, the traditional cloak of secrecy that is found in most offshore jurisdictions is a benefit which is valued by many U.S. clients who wish to keep a low profile for a variety of reasons. Typically, unless the debtor has committed a crime that is also a crime in the jurisdiction in which the trust is located, an offshore jurisdiction will not provide confidential information about the debtor's affairs without the debtor's consent. Since most offshore financial centers are tax havens with no income or estate taxes, no "tax crimes" are legally possible. Thus, almost all offshore jurisdictions will decline to cooperate with criminal tax investigations of the United States or United Kingdom.

5. Unambiguous Fraudulent Transfer Laws and Statute of Limitations.

Few offshore jurisdictions condone a fraudulent conveyance. However, most offshore jurisdictions have attempted to clarify the issue of fraudulent conveyance by drafting clearly defined fraudulent conveyance legislation. This modern legislation has attempted to eliminate many of the ambiguities and unpredictable results that have caused uncertainty for both debtors and creditors alike, both in the United States and in the United Kingdom. Likewise, most jurisdictions have acted to shorten the statute of limitation periods applicable to fraudulent conveyances. (Contrary to popular belief, the Cayman Islands, commonly thought as a debtor haven, has a six-year statute of limitations!)

6. Avoids Need For Pre-Marital Agreements.

Regrettably, the sacrament of marriage is not as sacred as it once was. It is not uncommon to have a U.S. client that is working on his third marriage. If the client has begun to accumulate wealth, notwithstanding prior divorces, future marriages can continue to be problematic when the issue of prenuptial agreements is first discussed. The need for a pre-marital agreement can be avoided altogether through the establishment of an international trust prior to marriage. It not only avoids the unpleasant task of asking a future spouse to sign a pre-marital agreement, it also prevents the need to make the vast financial disclosure that is required under most state laws to make such agreements enforceable. In fact, the future spouse does not even need to know about the existence of the international trust. Upon divorce, the assets in the trust are safely and legally outside the jurisdiction of a divorce court.

7. Marital Property and Forced Heirship Laws Overridden.

A settlor may be surprised to learn that in most states he will not be able to freely dispose of his property through his Will at the time of his death. Forced heirship laws throughout the United States grant spouses and children of the decedent certain heirship rights in the decedent's estate. These types of problems can be properly addressed through the use of an international trust established in a jurisdiction that has adopted legislation to prevent the application of forced heirship laws and forced marital property laws in the debtor's home jurisdiction.

B. The Consolidated Wealth Preservation Trust.

A typical international trust established by a U.S. person is intentionally drafted to qualify as a "grantor trust" for U.S. tax purposes. Failure to do so will result in a transfer to the trust being treated as (i) a taxable

gift and (ii) a taxable "sale or exchange" of the asset transferred to the trust. However, if established as a grantor trust, any assets held by the trust will be subject to estate tax upon the settlor's death. Thus, even if the primary goal of establishing the trust is the settlor's desire to achieve asset protection for the client and the client family and heirs, the client's planner should consider and integrate into the international trust structure estate planning strategies that will help reduce the estate tax burden of assets held within the trust upon the settlor's death. However, to enhance the likelihood that such planning will succeed, it is important, particularly in an offshore setting, that the resulting structure be established as part of an arm's length transaction with an independent trustee and minimal retained controls on the part of the settlor.

XIV. THE BANKRUPTCY REFORM ACT OF 2005

After eight years of fierce debate and near misses, Congress finally passed the most sweeping overall of bankruptcy law when, on April 15, 2005, by a vote of 302–126, the U.S. House of Representatives passed the **Bankruptcy Abuse Prevention and Consumer Act of 2005**. The House vote came approximately one month after the Senate voted 74-25 to pass the Bill. All proposed amendments to the proposed legislation were summarily defeated in the House of Representatives as part of a concerted effort to pass the legislation without any amendments to the version passed by the Senate one month earlier. President Bush signed the 2005 Bankruptcy Reform Act into law on April 20, 2005. The reforms take effect on October 17, 2005, although some parts of the legislation became effective immediately upon the President signing it.

As discussed earlier, bankruptcy reform had lingered in Congress for eight years before it was finally passed by Congress and signed by the President. The legislation was heavily promoted by credit card companies, credit unions and banks with the primary goal of forcing debtors to repay a portion of their indebtedness, according to their ability to pay, rather than to automatically allow debtors to discharge their debt by filing for Chapter 7 bankruptcy protection and easily discharging their debts (except for those few debts that cannot be discharged in bankruptcy).

While the legislation is certainly designed by the finance industry to minimize its losses in the consumer debt arena, the primary provisions of the 2005 Bankruptcy Reform Act are equally applicable to high net worth individuals who may be forced into an involuntary bankruptcy situation as a result of an unexpected financial setback. Should that happen, the unfortunate client, now a debtor in bankruptcy, may be surprised to learn that he or she will be required to pay his or her disposable income if in a Chapter 13 proceeding, to a bankruptcy trustee for five years, based primarily upon a definition of "disposable income" determined using IRS National and Regional Standards.

Although provisions of the 2005 Bankruptcy Reform Act can also present problems for professionals and other high income earners who suddenly find themselves in bankruptcy. Among those are the $125,000 limitation on the homestead exemption, the new $1 million cap on individual retirement accounts, and the ability of a bankruptcy trustee to set aside certain transfers to "self settled trusts or similar devices" which occurred ten years of a bankruptcy filing.

A. "Means Testing" or "Everyone Must Pay According to Their Means."

One of the principal goals of bankruptcy reform has always been to force debtors to pay a portion of their debts according to their individual ability to pay, thus the term "means testing." The process contemplates a two-part test to determine whether an individual is truly entitled to seek a Chapter 7 liquidation of his or her debts. However, while the two tests are primarily mathematical in nature, they are not necessarily absolute. Thus, an individual who would, on the basis of available data, technically qualify for a Chapter 7 liquidation, may nevertheless be required to undergo a Chapter 13 reorganization if the bankruptcy filing is found to be "abusive." Likewise, someone who, according to the two-part test, does not qualify for a Chapter 7 liquidation and discharge may, under special circumstances, be allowed to seek a "fresh start" by allowing the individual to pursue a Chapter 7 liquidation and discharge of all debts.

1. Median Income Test.

The first test is a "median income test." If a debtor's current month income, averaged over the prior six months, exceeds the "state median income" for a family of the same size, a Chapter 7 filing is presumed to be abusive or, to put it another way, the debtor's only bankruptcy relief is a Chapter 13 reorganization. In a Chapter 13 reorganization, a debtor makes monthly payments to a bankruptcy trustee for a period of up to five years. While the sum of all such payments are rarely sufficient to liquidate 100% of the debtor's indebtedness, it is nevertheless favored by creditors over a Chapter 7 liquidation and discharge.

2. Means Test.

The second part of the two-part test, the "means test," is basically designed to calculate the individual's

"disposable income" available for payment to creditors. If the debtor's current monthly income, again averaged over six months, reduced by "allowable expenses," exceeds that amount which is allowed under the new legislation for a family of the same size, assuming the debtor passes the "median income test," the debtor would be required to pay such disposable income to a bankruptcy trustee for a period up to five years.

While such a requirement might seem reasonable on its face, the required payment of an individual's monthly disposable income to a bankruptcy trustee takes substantially increased significance when taking into account how "allowable expenses" are determined. Specifically, the new legislation defines allowable expenses as those determined using the "National and Local Standards, and Other Necessary Expenses" as provided in Collection Financial Standards issued by the Internal Revenue Service, without regard for debt payments. Anyone who has experience in working with IRS disposable income calculations knows that the amounts allowed as reasonable living expenses by the IRS are minuscule compared to the amounts that professionals, executives, and other high income earners are accustomed to spending, based upon their available income. In the foregoing example, the net affect will require such debtor to pay most of his income to a bankruptcy trustee, thus substantially changing the lifestyle of himself and his family.

B. $125,000 Homestead Exemption Limitation.

One provision that was controversial when first offered but unchanged during the last four years of debate on bankruptcy reform was the $125,000 cap on the homestead exemption available to a debtor in bankruptcy. When first suggested during earlier versions of reform legislation, the limitation was intended to be a universal limitation applicable to all bankruptcy filings in all situations. However, after the election of Texas Governor George W. Bush as President, President Bush, along with the efforts of Texas Senator Kay Bailey Hutchinson and others, were able to convince Congress to limit the exemption limitation to those who abuse the homestead exemption statutes available in some states by relocating to those states just prior to a bankruptcy filing.

In the end, the legislation that was adopted by Congress allows a debtor to benefit from the liberal homestead exemptions available in some states, such as Texas and Florida, who have unlimited homestead exemptions, ***provided*** that the debtor has resided in his or her homestead for 1215 days prior to the filing of a bankruptcy petition. In calculating the 1215-day requirement, a debtor is allowed to "tack on" any holding period associated with the debtor's prior homestead so long as both homesteads are located within the same state. If the debtor does not meet the 1215-day residency requirement, the homestead exemption will be limited to $125,000. Even if the debtor meets the 1215-day residency requirement, the debtor will nevertheless be limited to the $125,000 homestead exemption limitation if the debtor is indebted for debt arising from violations of certain federal securities laws, RICO civil penalties or a criminal act, intentional tort or willful or reckless misconduct causing serious physical injury or death to an individual.

Even if the debtor otherwise qualifies to claim his or her entire homestead as exempt, the debtor will nevertheless be limited to a maximum $125,000 homestead exemption, no matter how long the debtor has resided in the state or in his homestead, if the debtor is indebted as a result of:

- Violation of federal securities laws or similar state laws;
- RICO civil penalties; or
- A criminal act, intentional tort or willful ***or reckless misconduct causing serious physical injury or death to an individual***.

The foregoing exemptions were not coincidental. They were a direct result of the Enron and WorldCom scandals, among others, where many of the individuals accused of wrongdoing within those companies also had the benefit of living in luxurious homes which were exempt from creditor claims under state law. The foregoing exceptions prevent such individuals from benefiting from liberal state exemptions, no matter how long they have lived in their home or resided in the state.

Although bankruptcy reform is but a few months old, the legislation has already generated significant litigation and court decisions, particularly in the area of the homestead exemption.

1. Equity Which Accrues Within 1215-Day Period.

In the Texas case of *In Re* Blair[104], the Bankruptcy Court for the Northern District of Texas addressed an attempt by a bankruptcy trustee to object to that portion of a debtor's home equity that had accrued within the 1215-day period prior to the debtor filing a voluntary Chapter 7 petition. In Blair, the debtors had claimed as exempt equity in their homestead valued at $688,606. The homestead had been acquired 1,773 days prior to the petition date. The home was located in University Park, an upscale subdivision in the Dallas, Texas area.

[104] *In Re* Blair, 334 B.R. 374 (Bkrtcy. N.D. Tex. 2005).

Southwest Security Bank, an unsecured creditor, filed an objection to the debtors' exemption of their $688,606 homestead equity. Specifically, Southwest objected to the exemption to the extent that it claimed as "any and all interest that the debtors acquired between January 27, 2002 "1215 days prior to the petition date) and the petition date which exceeds $125,000" citing 11 USC §522(p).

Southwest based its objection upon the wording in the revised §522(p), that provides that:

> "A debtor may not exempt any amount of interest that was acquired by the debtor during the 1215-day period preceding the date of the filing of the petition that exceeds in the aggregate $125,000 in value."

Unfortunately, the term "interest," which must be acquired by the debtors during the 1215-day period to trigger the new homestead cap, is not defined. Southwest Bank argued that the debtor's equity in the homestead was in excess of the $125,000 cap and that the ***increase*** in the equity position in the house during the 1215-day period above $125,000 was subject to the statutory cap and was therefore not exempt.

The court addressed the matter by noting that one does not actually "acquire" equity in a home. One acquires title to a home. The "interest" that the debtors had acquired was the actual purchase of the home, which was completed well before the 1215-day period mandated by the new bankruptcy law in order to take advantage of the liberal homestead exemptions available under Texas law. Thus, the court held that the "interest" held by the debtors in their homestead was outside the 1215-day period and not subject to the $125,000 cap.

2. "Trading Up" to Higher Value Home.

In the Blair case discussed above, the court, in rationalizing its decision, noted that the new §522(p) did not attempt to exclude from a state's favorable homestead exemption "any amount of such interest does not include any interest transferred from a debtor's previous principal residence (which was acquired prior to the beginning of such 1215-day period) into the debtor's current principal residence, if the debtor's previous and current residences are located in the same state."[105] Thus, Congress essentially allowed for rollover by debtors of the equity in one home to another home located in the same state. In other words, a debtor is not subject to the homestead cap if he takes the proceeds of his first residence and reinvests them in a second residence even within the prescribed period of the 1215-day period of §522(p). In Blair, had the court adopted the creditor's interpretation of §522(p), the result would have been at odds with the language which allows a debtor to "rollover" his equity into a new residence even if such new residence was purchased within the 1215-day period prior to the filing of a bankruptcy petition.

In the Florida case of *In Re* Wayrynen[106], the court was faced with the issue where the debtor had acquired a previous residence outside of the 1215-day safe harbor period but, had acquired a new one within the 1215-day period. The trustee claimed that, since the new residence was acquired within the 1215-day safe harbor period, the debtor was strictly limited to the $125,000 homestead limitation provided by §522(p)(1)(A). Since the value of the new residence was listed at $150,000 on the debtor's bankruptcy schedules, the value exceeded the $125,000 exemption for a residence thus resulting in a differential of $25,000 which represented "non-exempt property." However, the court felt that such analysis misconstrued §522(p)(2)(B), noting that:

> "The statute is clear that the limitation contained therein applies to that portion of the value of a debtor's residence, acquired **within** 1215 days of the petition date, which **exceeds** $125,000. In addition, however, the extent of the limitation is determined **only after deducting** from the value of a debtor's current residence that portion of the property's value attributable to the debtor's ownership of a previous residence, provided that the previous residence is located within the same state as the current residence and was acquired in excess of 1215 days before the petition date."

In analyzing the specific transaction in Wayrynen, the court concluded that the "interest" transferred from the debtor's previous residence into his current residence amounted to $150,500. Since the amount of the "interest" transferred from the debtor's previous principal residence ($150,500) which is excluded in calculating the "interest" of the debtor subject to being exempted, actually exceeded the value of the debtor's present principal residence ($125,000), there was no portion of the value of the debtor's present principal residence which constituted non-exempt property.

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105 11 U.S.C. §522(p)(2)(B)

106 *In Re* Wayrynen, 332 Br. 479 (Bkrtcy. S.D. Fla. 2005)

While the debtor in Wayrynen was able to exempt the entire amount of equity in the second home, the case nevertheless supports the proposition that a substantial "upgrade" in homes within the 1215-day safe harbor period will not exempt the whole of the debtor's equity in the new home to the extent that the debtor's overall equity in the new homestead exceeds $125,000 after deducting the amount of exempt equity rolled into the new home from a prior residence.

In essence, the court's holding makes clear that an individual with an otherwise exempt home will not be able to succeed in substantially "upgrading" his position by taking the equity in their old home and rolling it into a new home, within the 1215-day period, if the debtor acquires a substantial increase in equity by investing into the new home significant amounts of excess cash that would clearly not be exempt under bankruptcy law. While the equity which had accrued in the prior residence will always be protected, any equity in excess of the already exempt preexisting equity will be subject to a new 1215-day holding period in order to be exempt from the $125,000 cap found in §522(p).

C. $1 Million Cap on IRA's.

Early versions of proposed bankruptcy reform during the Clinton administration actually included a $1 million "cap" on the amount of retirement benefits that could be protected in bankruptcy proceedings, regardless of the type of plan involved. Thus, under legislation that was actually passed by Congress but never became law, all retirement plans, including those governed by ERISA, would have been capped at $1 million in bankruptcy proceedings. However, by the time that the 2005 Bankruptcy Reform Act was enacted, the only significant limitation that remained was that which applied to individual retirement accounts ("IRA's") or Roth individual retirement accounts (ROTH IRA's) under §§408 or 408A of the Internal Revenue Code. However, in calculating the amount of the IRA or ROTH that is subject to the $1 million cap, there is excluded from the calculation any rollovers which qualified as such under IRC §§402(c), 402(e)(6), 403(a)(4), 403(a)(5), or 403(b)(8). Since most IRA's with large balances are a result of a qualified rollover, it is ROTH IRA's that are more likely to be subject to the $1 million limitation in bankruptcy. Of course, these limitations, as will all exemption limitations in the Bankruptcy Code, are only applicable to the debtors in bankruptcy. If the debtor is not involved in bankruptcy proceedings, state law exemptions can apply. However, these limitations can be forced on a debtor through an involuntary bankruptcy filing by a qualified creditor or group of creditors.

D. Asset Protection Trusts Survive Last Minute Assault.

Although the 2005 Bankruptcy Reform Act is basically the same bill that had been debated and had actually passed both houses of Congress in prior years, the issue of asset protection trusts was a last minute issue that arose as a result of a newspaper article that appeared in the ***New York Times*** on March 2, 2005. In that article, the ***New York Times*** referred to legal specialists who said that the proposed law left open *"an increasing popular loophole that lets wealthy people protect substantial assets from creditors even after filing for bankruptcy."* The newspaper article focused on the use of domestic asset protection trusts that, since 1997, had been approved for use in Alaska, Delaware, Nevada, Rhode Island, Missouri, Oklahoma, South Dakota, and Utah. Thus, while Congress had taken action to limit the abuse of unlimited homestead exemptions in states like Florida and Texas, it left untouched what one law professor in the article described as "the millionaire's loophole." The fact that the proposed bankruptcy reform has been pending for so many years was cited as one possible reason for this apparent oversight on the part of Congress: *"Perhaps because the current bill was written so long ago, some legal authorities say, it does not address the new state laws that have allowed asset protection trusts to flourish."*

New York's own U.S. Senator Charles Schumer was quick to react by introducing a series of amendments to the proposed bankruptcy bill that specifically targeted asset protection trusts. The amendments would have enabled the bankruptcy trustee to set aside or "void" any transfer of the debtor's property into an asset protection trust if:

- Such transfer occurred within ten years of filing for bankruptcy;
- The aggregate of all such transfers exceeded $125,000; and
- The trust was a "self-settled trust" in which the debtor had a beneficial interest.

In Senate debate over Senator Schumer's proposed amendment, supporters of the proposed amendment wisely offered a laundry list of multiple examples of alleged abuses, including WorldCom's co-founder John Porter, financier Paul Bilzerian and even actor Burt Reynolds who had allegedly abused the bankruptcy system by utilizing local law to shelter millions of dollars in assets. Thus, just as the Senate had placed a $125,000 cap on the homestead exemption in certain cases, Senator Schumer and his supporters argued that a similar $125,000 "cap" needed to be placed on asset protection trusts.

In response to the Schumer amendment, Missouri Senator James Talent offered his own compromise amendment that would have enabled a bankruptcy trustee to set aside only those transfers that were done to defraud creditors, particularly transfers by debtors involved in securities fraud and similar crimes. However, in the opinion of some commentators, including this author, what helped doom the Schumer amendment was the fact that one of the states targeted by Senator Schumer's proposed legislation was the state of Utah, which was represented by the well respected and powerful chairman of the Senate Judiciary Committee, Senator Orrin Hatch. The comments by Senator Hatch on the floor of the Senate on March 10, 2005, were short and to the point:

> "Mr. President, one can have self-settled trusts. What the amendment of the distinguished Senator from New York does is do away with essentially all self-settled trusts. Frankly, Senator Schumer's amendment is so broad that it covers all settled trusts, not just fraud.
>
> The amendment of the distinguished Senator from Missouri covers fraud, and he does it in the appropriate way, a legal way, the way it should be done."

Ultimately, it was Senator Talent's amendment to the bankruptcy bill that was incorporated into the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. It did so by adding a new paragraph to §548 of the Bankruptcy Code that governs "fraudulent transfers and obligations." The new language in §548 of the Bankruptcy Code provides as follows:

> "(e)(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if-
>
> (A) such transfer was made to a self-settled trust or similar device;
> (B) such transfer was by the debtor;
> (C) the debtor is a beneficiary of such trust or similar device; and
> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.
>
> (2) For the purposes of this subsection, a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by-
>
> (A) any violation of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws; or
> (B) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78l and 78o(d)) or under section 6 of the Securities Act of 1933 (15 U.S.C. 77f)."

The critical language in the new legislation is that which describes the type of transfer covered by the amendment. As revised, Bankruptcy Code §548(e)(1)(D) will enable a trustee to set aside transfers made "***with actual intent to hinder, delay, or defraud***" a creditor. It is the inclusion of the words "actual intent" that was severely criticized by Senator Schumer after enactment of the so-called compromised legislation. The requirement that the bankruptcy trustee prove "actual intent" is, in Senator Schumer's view, an insurmountable obstacle in most cases. However, other commentators have also been critical of what is clearly less than ideal drafting. For example, the term "self-settled trust" is defined in different ways within the amendment itself. In addition, some practitioners have already taken the position that the language of the amendment itself and its focus of securities law violations, taken together with the debate on the Senator floor, including comments by the author of the amendment, support the proposition that the amendment targets only those transfers that are made in anticipation of a judgment, settlement, civil penalty, equitable order or criminal fine incurred as a result of the various security law violations described in the amendment. Such proponents argue that specifically targeting those types

of wrongful acts only serves to underscore the intention of the amendment to apply only to those transfers that are made in response to the securities law violations referenced in the new §548(e)(2). However, a simple review of the "definitions" section of the Bankruptcy Code makes clear that the word "includes" is not intended to be a term of "limitation." In other words, the mere fact that a portion of the Code describes that which it "includes" does not mean that it is intended to "exclude" other items not listed in the particular part of the Code where the language is used.

A more relevant question is attempting to define the type of structure, other than a self-settled trust, to which the ten-year "look back" is applicable. The new §548(e)(1)(A) specifically targets a transfer made to "a self-settled trust ***or similar device***" [***emphasis added***]. It is not at all clear what is intended to be included in the definition of a "similar device." However, the foregoing provision could possibly be interpreted to include any type of structure to which a debtor transfers property, and in which the debtor is a beneficiary of the structure such as an annuity, some life insurance policies and probably an interest in a legal entity, including a FLP or FLLC, since all of the foregoing structures can, if properly designed, provide an element of asset protection to the client who established the structure. This is particularly true in states such as Texas that provide unlimited protection for an individual's interest in an annuity or life insurance policy, including its cash surrender value.

E. Can the Estate Planner Prove the Settlor was Solvent 10 Years Ago?

When doing estate planning for a client, estate planners consider the need to investigate and be prepared to prove the solvency of their client notwithstanding the likelihood that the estate planning strategy adopted for the client involves gratuitous transfers such as a contribution to a trust. Yet, in the opinion of this author, the 2005 Bankruptcy Reform Act makes it prudent, if not highly advisable, to have a client who is involved in estate planning or tax motivated transfers execute an affidavit at the time of the transfer to help document the solvency of the client at the time a significant transfer is made. Such an affidavit, particularly if supported by contemporaneously third party documentation, will be extremely vital should the client-settlor encounter financial difficulties within 10 years after making a large gratuitous transfer or, for that matter, any type of transfer which is considered to be a transfer of the type contemplated under Bankruptcy Code §548(e)(1)(B). In fact, some estate planners fail to take into account the possibility that gratuitous transfers into an estate planning structure can be challenged as fraudulent transfers under the law of all 50 states, most of which have four year statute of limitations. Now, estate planners and other estate planning advisors must take into account the ***10 year*** statute of limitations which the 2005 Bankruptcy Reform Act provides a bankruptcy trustee in which to challenge transfers that a bankruptcy trustee may allege were made with actual intent to hinder, delay or defraud a creditor.

Professionals involved in doing international trust work routinely have such affidavits of solvency executed as part of a client's overall international wealth preservation plan. In fact, trust companies in states that allow for self settled trusts have also become accustomed to requiring such affidavits from settlors of a self settled trust. However, in light of the 10 year statute of limitations now found in the Bankruptcy Code, it is probably prudent to have an affidavit of solvency executed by a client that is making any type of significant gratuitous transfer to any type of estate planning or tax motivated structure. This should probably include transfers to family limited partnerships and related entities as it is still unclear what is meant in the bankruptcy code when referring to a transfer to a "self-settled trust ***or similar device****."* An example of one form of affidavit of solvency is included herein as an exhibit to this paper strictly for illustrative purposes.

XV. CONCLUSION

The uncertainties of our judicial system coupled with the increased exposure to seemingly uncontrollable jury awards has resulted in professional advisors re-examining the benefits associated with the establishment of a domestic or international wealth preservation structure with strong asset protection features incorporated into such structures. The growing trend to allow creditors and other claimants to pierce a domestic spendthrift trust, usually established by the parents or grandparents of the beneficiary, is both alarming and, except in rare circumstances, something that could have been avoided though proper planning. The fact that the trend to pierce spendthrift trusts has been recognized by the Restatement on Trusts, 3rd and now the new Uniform Trust Act is even more disturbing. What is incredibly ironic about this trend is the fact that twelve (12) states have now abolished the historic prohibition against self-settled trusts and have allowed settlor-beneficiaries of such trusts to benefit from the law previously reserved only to beneficiaries of spendthrift trusts established by a third party.

Likewise, the ownership interest of family members in a family limited partnership or family limited liability company face multiple threats to their ownership interest that can often be easily addressed

through careful planning. Even in a divorce setting, it is not surprising to learn that divorce courts have used this growing trend to pierce structures to reach assets in trusts previously thought to be immune from outside threats.

All business and estate planning professionals should become familiar with these potential threats and, if necessary, take such steps as are necessary to significantly increase the probability that the intended beneficiaries of a trust, including an irrevocable life insurance trust or other estate planning structure, will ultimately be able to benefit from the client's estate planning strategy. However, just as important is the need to protect the client's wealth from the litigation and other risks so common in today's litigious society. Such steps may include establishing an estate planning strategy that incorporates both domestic and/or offshore wealth preservation structures. With careful planning, an estate planning strategy that includes a domestic or offshore wealth preservation structure can provide the client with significantly better protection against the ever increasing threats to wealth in today's litigious society.

APPENDIX "A" - Sample Domestic Trust Protector Provision
TRUST PROTECTOR

6.01 Appointment of Trust Protector. There shall be a Protector of each trust created by or pursuant to this Trust Agreement. The initial Protector (herein referred to as the Trust Protector, and which term shall include any successor Protector from time to time acting hereunder) shall be **_____.** Should _____ shall for any reason fail or cease to serve as Trust Protector, then _____ shall serve as the successor Trust Protector. If _____ shall for any reason fail or cease to serve as a Trust Protector, then _____ shall serve as the Trust Protector

(a) Every successor Protector shall succeed his or her predecessor in all powers and discretions.

(b) A Trust Protector may resign by written and acknowledged instrument delivered to the Trustee and all then current beneficiaries of the Trust. If the Trust Protector resigns, becomes incapacitated, or otherwise ceases to act as such and no successor Protector is available to assume such role, the Trustee, subject to the consent of the beneficiaries of the subject trust as provided for herein, shall appoint a successor Protector hereto, but may not appoint itself or any party related to or subordinate to itself as Protector.

(c) Any appointment of a Protector by the Trustee as herein provided must be consented to, by majority vote, by the beneficiaries of the applicable trust (or Trust). Failure by the beneficiaries of the applicable trust (or Trust) to consent to such appointment within thirty (30) days after notice of such appointment is given to them by the Trustee, shall be deemed for all purposes hereof as a failure by the necessary beneficiaries to acquiescence to the proposed appointment.

(d) Any appointment of a successor Protector shall be by written instrument delivered to the appointee and shall be effective at the time or under the conditions specified in such instrument and shall be endorsed on or attached to this instrument and signed by the new Protector Under no circumstances shall any of the following persons be entitled to serve as the Trust Protector: (i) any Settlor, (ii) any Trustee who is removed by a Trust Protector, (iii) a currently serving Trustee (and if a Protector becomes Trustee, such Protector shall resign as the Trust Protector). Notwithstanding any other provision of this Trust Agreement, no person shall be eligible to serve as Trust Protector if such person is a beneficiary of any trust held under this Trust Agreement or if such person is a related or subordinate party within the meaning of Section 672(c) of the Internal Revenue Code with respect to any beneficiary of any trust held under this Trust Agreement.

6.02 Powers of Trust Protector. In addition to other powers and discretions otherwise given to a Trust Protector by this instrument, the Trust Protector for each trust created hereunder shall have the following discretionary powers, to be exercised by written instrument, signed and acknowledged by the Trust Protector and delivered to the then serving Trustee ("Notice"):

(a) Removal / Appointment of Trustee. The power to (i) to remove any person, as a Trustee of such trust at any time and for any reason, or (ii) to appoint a successor Trustee for such trust (if no other successor Trustee herein named is willing to serve, or all such named successor Trustees have been removed, deemed unfit to serve, or ceased to serve by action of the Trust Protector or otherwise), or (iii) at any time, to appoint one or more co-trustees for any trust hereunder as to which any individual or entity is serving as sole Trustee. If the Trust Protector intends to appoint an individual as a Trustee or co-trustee hereunder, the Trust Protector shall consider the federal estate and income tax consequences to that individual, the trust and the beneficiaries of such appointment.

(b) Distributions. The Power to consent, in writing, to the distribution of all or any part of the Trust Estate to any beneficiary of any trust established hereunder.

(c) Amendment. The power to join with the Trustee to jointly amend the trust from time to time, and in such manner, as the Trustee and Trust Protector believe, in their discretion, will facilitate

the efficient and effective administration of the Trust in accordance with the intentions of the Settlors, provided however, that no such amendment shall have the effect of changing or altering the beneficiaries of this trust or their beneficial interests.

(d) Accounts for the Trust Estate. The power to consent in writing to the establishment or opening of any banking, investment, brokerage, custodial or other financial account into which Trust Assets shall be deposited or managed, provided, however, that no such Protector consent shall be required if any such account is initially funded with funds deposited directly into the account by the Settlors.

(e) Change of Situs. The power to designate the law of any jurisdiction (under which the terms of any trust created by or pursuant to this Trust Agreement shall be capable of taking effect) to be the governing law of any trust created by or pursuant to this Trust Agreement, whether such jurisdiction is in or outside the United States, and to declare that such trust shall thereafter be governed by and take effect according to the laws of the jurisdiction so designated, the courts of which shall become the forum for the administration of such trust, as well as all matters applicable to the administration thereof. Such a designation and declaration shall be set forth by written instrument which shall contain the powers and provisions which are necessary to enable such trust to be capable of taking effect under the laws of such jurisdiction, and which may also contain such other powers and provisions as the Trust Protector may determine to be in the best interest of the beneficiaries, provided that such powers and provisions do not infringe upon any rule against perpetuities that is applicable to such trust.

6.03 Demand Trustee Accounting. The Trust Protector shall be kept reasonably informed by the Trustee regarding the activities, assets, liabilities and income of the Trust, provided however, that the Trust Protector shall have the power, exercisable at any time, to demand an accounting by the Trustee, setting forth the receipts, disbursements, and distributions of both capital and income during the period of accounting and the invested and uninvested capital and undistributed income that is in existence at the beginning and at the end of such accounting period.

6.04 Trustee Bond. Notwithstanding the provisions of Section 3.02(e), the Trust Protector shall have the power, exercisable at any time, to require in writing that the Trustee, or any person or entity to whom the Trustee has delegated a power pursuant to any Article of this Trust, be required to give a bond or other security for the faithful administration of its or their duties under this Trust Agreement.

6.05 Powers Personal. The duties and powers of the Trust Protector shall be personal and shall cease upon the death of the person holding such office (if an individual) or upon the dissolution of the entity acting as Protector (in the case of a corporation or other entity acting as Protector). The powers of the Trust Protector shall not be capable of being delegated or of being exercised by any representative (whether a personal representative or otherwise), agent, receiver, or liquidator of the Trust Protector.

6.06 Other Limitations on Protector Powers. Notwithstanding anything in this Article VI to the contrary, the Trust Protector has no right or authority to take any action that will directly or indirectly benefit any person who is not an intended beneficiary of this trust, or that will be detrimental in any way to the beneficiaries of this Trust or inconsistent with the purposes of this Trust Agreement.

6.07 Consent by Protector. Where the Trust Protector must give consent to the exercise of any power or discretion hereunder by Trustee, the Trust Protector may veto the exercise of any such power or discretion, and accordingly the Trustee shall be required to provide the Trust Protector with reasonable prior notice before any such powers or discretions may be exercised so as to allow the Trust Protector reasonable advance opportunity within which to veto or refrain from vetoing the exercise of the power or discretion. The Trust Protector's exercise or nonexercise of this veto power shall be communicated in writing to the Trustee and failure to so communicate in a timely fashion, provided notice is actually received by the Trust Protector, shall be treated by the Trustee as a veto by the Trust Protector of the proposed exercise of the power or discretion; however, if the Trustee, or in the case of multiple Trustees, one or more of the Trustees reasonably believe that failure by the Trust Protector to so communicate is due to the Trust Protector being restrained or enjoined from doing so, then such failure to communicate

shall be treated by the Trustee and deemed for all purposes hereof as acquiescence by the Trust Protector to the proposed exercise of the power or discretion.

6.08 Compensation. The Trust Protector, if it is a company, shall be entitled to act as Protector on its usual terms and conditions in force from time to time, including (in addition to reimbursement of such company's proper expenses, costs, and other liabilities) the right to remuneration. The Trust Protector, if it is an individual, shall be entitled to remuneration for its services as such, including the right to reimbursement of proper expenses, costs, and other liabilities. Notwithstanding the foregoing provisions of this Section 6.08, however, the Trust Protector's charges and remuneration shall not exceed reasonable and customary charges and remuneration for similar services charged by corporate Protectors in the same geographic area.

6.09 Removal of Protector. Notwithstanding the provisions of Section 6.01 above, the beneficiaries of the applicable trust (or Trust) shall have the power to remove a Protector. Any removal of a Protector pursuant to this Section 6.09 shall become effective immediately upon notice of such removal being given pursuant to this Trust Agreement. A Protector removed pursuant to this Section shall not have the power to appoint a successor Protector. When any Protector is removed pursuant to his Section 6.09, a successor Protector shall succeed to the removed protector or, if there is no successor Trust protector, shall be appointed pursuant to the provisions of Section 6.01 above as if the Trust Protector had resigned, become incapacitated, or otherwise ceased to act, and no successor Trust Protector was willing or able to act as Trust Protector. Any successor Protector who replaces a Protector removed pursuant this Section 6.09 shall succeed to all powers and discretions of the Trust Protector under the Trust Agreement.

APPENDIX "B" - Sample Affidavit of Accuracy and Solvency

AFFIDAVIT OF ACCURACY AND SOLVENCY

STATE OF TEXAS §
§
COUNTY OF DALLAS §

COMES NOW the undersigned, **John C. Doe ("Settlor")**, who being first duly sworn upon oath, deposes and states, covenants, represents, and warrants as follows:

1. That to the best of my knowledge and belief, the information reflected on the attached **Schedule A** and all annexures thereto is true and accurate and provides a total picture of my entire financial situation including all claims, debts, loans, lawsuits or contingent liabilities (such as indemnities, guarantees or anticipated lawsuits) immediately prior to any property transfers by me to that certain trust settled by that certain Trust Agreement dated April 15, 2011 by and between **John C. Doe**, of Dallas, Texas, United States of America, as Settlor, and XYZ Company (Delaware), Inc., of Wilmington, Delaware, as Trustee, settled under the Delaware Qualified Dispositions Trust Act, *12 Del. §3570, et seq.* and known as **The John C. Doe 2011 Family Trust** ("the Trust") or to any limited partnership or other holding entity in which the Trust has or will have an interest.

2. Where property has already been transferred from me to the Trust or to any limited partnership or other holding entity in which the Trust has or will have an interest I was at that time solvent and able to pay my then reasonably anticipated debts including any claims and existing or anticipated lawsuits against me as they were to come due from the balance of my property after such transfer.

3. I have or will have at the time of transfer full right, title and authority to transfer all assets transferred or proposed to be transfer to the Trust.

4. Following any contemplated or proposed transfer of my property to the Trust or any limited partnership or other holding entity in which the Trust has or will have an interest I will be solvent and able to pay my reasonably anticipated debts including any claims or lawsuits against me as they come due from the balance of my property after such transfer.

5. I have filed all federal and state income tax returns which are required to be filed, and have paid all taxes as shown on said returns and on all assessments received as a result of any of them to the extent that such taxes have become due.

6. Neither the execution nor delivery of this Affidavit of Accuracy and Solvency, the Trust Agreement, or any document executed in connection therewith, will conflict with, or result in a breach of the terms, conditions or provisions of, or constitute a default under any agreement or instrument to which I am is now a party or by which I may be bound.

7. This Affidavit of Accuracy and Solvency and each document executed in connection with or ancillary to the Trust Agreement have each been duly and validly executed, issued and delivered by me and constitute valid and legally binding documents enforceable in accordance with their respective terms.

8. The execution, delivery and performance by me of this Affidavit of Accuracy and each document executed in connection with or ancillary to the Trust Agreement does not and will not require (i) any consent of any other person; or (ii) any consent, authorization or other approval of any court, arbitrator, administrative agency or other governmental authority.

9. All information supplied and statements made to the Trustee or on behalf of me prior to, contemporaneously with or subsequent to the execution of this Affidavit of Accuracy and Solvency are and shall be true, correct, complete, valid and genuine; all financial statements of I have furnished to the Trustee or are attached hereto fairly present my financial condition as of the date thereof and for the period then ended.

10.I am not in default with respect to any order, writ, injunction, decree or demand of any court or any governmental authority.

11.No representation or warranty contained in this Affidavit of Accuracy and Solvency and no statement contained in any certificate, schedule, list, financial statement or other instrument furnished by or on my behalf to the Trustee contains, or will contain, any untrue statement of material fact, or omits, or will omit, any statement of a material fact necessary to prevent the statements contained herein or therein from being misleading.

12.I do not contemplate filing for relief under the provisions of the U.S. Bankruptcy Code, nor am I involved in any situation that I reasonably anticipate would cause me to file for relief under any Chapter of the U.S. Bankruptcy Code in the future.

13.I have read and understand the description of the Money Laundering Control Act, 18 U.S.C. §1956, and confirm and represent that none of the assets which I have transferred or which I may transfer to the Trust have been derived from any of the activities specified in such Act.

14.I will comply with all of the reporting requirements as stipulated from time to time by the United States Internal Revenue Service in respect of the Trust, including reporting the creation of the Trust and any transfers of property to or distributions from the Trust.

15.I am not, to my knowledge, nor do I reasonably expect to be, under investigation by any Federal or State agency, or in violation of any statute administered by, or empowering the Internal Revenue Service, the Federal Trade Commission, the Securities Exchange Commission, the United States Postal Service, the Drug Enforcement Agency, the Department of Homeland & Security, or the Federal Bureau of Investigation.

FURTHER AFFIANT SAYETH NOT.

SETTLOR:

_____

John C. Doe

This affidavit together with all schedules and annexures to the schedules was **SUBSCRIBED AND SWORN** to before me, a Notary Public in and for the State of Texas, County of Dallas, by **John C. Doe**, affiant, this _____ day of _____, 2011.

Witness my hand and official seal.

_____
Notary Public - State of Texas