WILLMS, S.C.

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LAW FIRM

TO: Clients and Friends of Willms, S.C.

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RE: Asset Protection Planning

Asset protection planning is a hot topic for many people. This article summarizes various asset protection planning strategies, short of filing for bankruptcy. This article does not address creditor protection that could be obtained through bankruptcy.

In general, we do not recommend owning assets in your individual name (with some exceptions, such as retirement accounts that have appropriate beneficiary designations). Assets owned personally are more likely to be subject to creditor claims and are more likely to require a probate proceeding upon your death. For these reasons (among others), many of the suggestions explained in this article will involve transferring ownership of your assets to trusts and/or business entities.

Fraudulent Conveyance Doctrine

It is important to be aware of the doctrine of fraudulent conveyances before engaging in asset protection planning. While the particulars vary from state to state, a "fraudulent conveyance" is generally defined as a transfer made with the intent to hinder, delay or defraud a creditor. Assets transferred by a fraudulent conveyance are available to satisfy creditor claims, and engaging in a fraudulent conveyance can subject you to other civil and criminal penalties.

Whether a conveyance is fraudulent depends upon various factors that include, but are not limited to, (1) whether or not the transferor was solvent at the time of the transfer, and (2) whether the transferor was aware of creditor problems at the time of the transfer. Therefore we suggest that you have a financial statement prepared by your accountant that confirms you are currently solvent before engaging in asset protection planning.

It is not a fraudulent conveyance to structure your affairs in the most favorable manner allowed within the parameters of the law. The remainder of this article discusses various asset protection strategies. All of the strategies and suggestions presented in this article assume that you have already determined the transfer will not be a fraudulent conveyance.

Planning Suggestions

Following is a summary of various asset protection planning strategies.

1. Retirement Plans.

Federal and Wisconsin laws provide creditor protection to various types of retirement plans. As a result, retirement plan assets can be difficult for creditors to reach. There are three categories of retirement plans discussed below: (1) Qualified Retirement Plans, (2) Individual Retirement Accounts, and (3) Non-Qualified Retirement Plans. Qualified Retirement Plans provide the greatest asset protection under federal law, but Wisconsin law also provides some creditor protection to Individual Retirement Accounts and Non-Qualified Retirement Plans.

a. Qualified Retirement Plans.

Qualified Retirement Plans are subject to the Employee Retirement Income Security Act ("ERISA"). A retirement plan which is qualified under ERISA is absolutely protected from the plan participant's creditors pursuant to the 1992 decision of the United States Supreme Court in Patterson v. Shumate.

Pensions, profit-sharing plans, money purchase plans, cash balance plans, 401(k) and 403(b) plans are examples of qualified plans. Please note that for ERISA protection to apply there are numerous requirements that must be satisfied and you may not be the only participant in the plan. The plan can, however, be structured so that a significant percentage of the plan assets are held for your benefit.

b. Individual Retirement Accounts ("IRAs").

ERISA does not provide creditor protection to traditional, Roth or rollover IRAs outside of bankruptcy[i]. Creditor protection for IRAs outside of bankruptcy comes from state law. In this respect, IRAs are subject to the Wisconsin creditor protection laws that govern Non-Qualified Retirement Plans.

Wisconsin provides creditor protection to traditional IRAs to the extent discussed below for Non-Qualified Plans, and many commentators believe this creditor protection also extends to Roth IRAs (although this is not entirely clear under Wisconsin law). However, inherited IRAs are not creditor protected in Wisconsin.

c. Non-Qualified Retirement Plans.

Non-Qualified Retirement Plans include a variety of retirement plans that are not afforded the same tax benefits associated with qualified retirement plans. Stock appreciation plans, deferred compensation and phantom stock plans are examples. Non-Qualified Plans do not receive ERISA based creditor protection because they are not subject to ERISA. Retirement plans of self-employed business owners are also regarded as non-qualified for this purpose, even though they may qualify for the tax benefits afforded to qualified plans under the Internal Revenue Code.

Wisconsin Statute § 815.18 provides creditor protection to certain qualified and non-qualified retirement plans, defined as "assets held or amounts payable under any retirement, pension, disability, death benefit, stock bonus, profit sharing plan, annuity, individual retirement account, individual retirement annuity, Keogh, 401−K or similar plan or contract providing benefits by reason of age, illness, disability, death or length of service and payments made to the debtor." One of the important exceptions to creditor protection provided under Wisconsin law is that creditor protection for an "owner-dominated plan" for a debtor who is an "owner-employee" shall be limited to the extent reasonably necessary for the support of the debtor and the debtor's dependents. An "owner-dominated plan" means any plan under which 90% or more of the benefits or account is for the benefit of "owner-employees."[ii] In other words, Non-Qualified Retirement Plan assets should be creditor protected at least to the extent necessary to support yourself, and, if 11% or more of the retirement plan's assets are owned by an unrelated individual and other requirements are satisfied, all of your contributions to a Non-Qualified Retirement Plan should be exempt.

2. **Life Insurance.**

Wisconsin Statute 815.18(3)(f) provides that up to $150,000 of cash value in life insurance is exempt from the claims of creditors, so long as the insurance was issued and funded more than 24 months before the creditor's claim. However, the proceeds will be subject to the claims of the *beneficiary's* creditors.

Another option, to avoid your creditors and the beneficiary's creditors both during and after your lifetime, would be to establish an irrevocable life insurance trust to be both the owner and the beneficiary of your life insurance, as discussed further below.

3. Annuities.

Wisconsin law provides similar asset protection to annuities as it does to life insurance. Wisconsin Statute 815.18(3)(f) provides that up to $150,000 of an annuity is exempt from the claims of creditors, so long as the annuity was issued and funded more than 24 months before the creditor's claim. However, to the extent you use this exemption on life insurance, it reduces the amount of the exemption available to use on annuities, and vice versa.

For example, if you have $100,000 of cash value in life insurance that you wish to be creditor exempt pursuant to § 815.18(3)(f), only $50,000 of the exemption remains to be used on annuities.

4. Irrevocable Trusts.

Irrevocable trusts can be highly effective asset protection tools. Assets transferred to properly drafted and administered irrevocable trusts for the benefit of friends and/or family should be exempt from the claims of your creditors during your lifetime and at your death, provided the transfer does not constitute a fraudulent conveyance. In addition, unlike outright gifts, the trust agreements can be drafted so that the trust assets are also exempt from the claims of the trust beneficiaries' creditors.

There are gift tax consequences whenever you transfer assets into an irrevocable trust. The good news is that for at least 2011 and 2012, the lifetime federal gift tax exemption is $5,000,000 per persron. This means that you can make gifts that total up to $5,000,000 without any gift tax being due ("gifts" include transfers to irrevocable trusts). The federal gift tax exemption is scheduled to be reduced to $1,000,000 in 2013, unless if the law changes between now and then (as we expect).

There are two primary categories of irrevocable trusts: (1) irrevocable trusts that name persons other than you as the beneficiaries; and (2) irrevocable trusts that name yourself as a beneficiary. We will first discuss irrevocable trusts that name persons other than you as the beneficiaries. (Irrevocable trusts that name you as a beneficiary are discussed further below under "Domestic Asset Protection Trusts").

a. Irrevocable Life Insurance Trusts ("ILIT").

As discussed above, life insurance can be an effective asset protection tool. The benefits of life insurance can be combined with the benefits of an irrevocable trust if you establish an Irrevocable Life Insurance Trust. An unlimited amount of life insurance can be protected from your creditors both during your lifetime and upon your death if the policies are owned by the ILIT and name the ILIT as the beneficiary.

b. Crummey Trusts.

In addition to your currently $5,000,000 lifetime gift tax exclusion, you may gift up to $13,000 each year to as many people as you wish (commonly referred to as "annual exclusion" gifts). It is possible to make "annual exclusion" gifts to irrevocable trusts if the trusts include special provisions that allow the trust beneficiaries to withdraw contributions to the trust for a limited period of time (i.e. 30 days). These withdrawal rights are known as "Crummey" powers, and Trusts that include these withdrawal powers are known as "Crummey Trusts."

You could also make larger gifts to these trusts by using some of your lifetime gift tax exclusion. It may actually be advisable to make a one-time, initial, larger gift to the trusts in order to avoid some technical generation skipping transfer tax issues that would otherwise exist.

c. Qualified Personal Residence Trusts ("QPRTs").

Wisconsin law provides creditor protection to up to $75,000 of equity in your primary residence (except for mortgages, laborers', mechanics' and purchase money liens and taxes, etc.). However, a Qualified Personal Residence Trust (another type of irrevocable trust), or "QPRT" for short, may allow you to protect more than $75,000 of equity in your residence. You can also transfer a vacation home to a QPRT.

When a home is transferred to a QPRT, you would retain the right to use the residence rent-free for a specific number of years. After that time period is complete, you could still live in the house for the remainder of your lifetime, but may need to pay rent to the QPRT (which can be viewed as a good thing because this allows additional assets to be transferred into the QPRT, where it is creditor protected).[iii]

d. Domestic Asset Protection Trusts ("DAPTs").

Traditionally, all U.S. states refused to extend creditor protection benefits to irrevocable trusts when the person establishing and funding the trust was a beneficiary. However, in recent years, some states have established laws that grant creditor protection to trusts that name the grantor as a beneficiary. These trusts are commonly known as "Domestic Asset Protection Trusts." Currently, twelve states (Nevada, Alaska, South Dakota, Delaware, Tennessee, Rhode Island, New Hampshire, Wyoming, Utah, Missouri, Oklahoma and Colorado) have enacted laws that allow DAPTs.

Wisconsin law does not currently allow for domestic asset protection trusts. However, it is possible for a Wisconsin residence to create a domestic asset protection trust in one (or more) or the twelve states that do allow DAPTs. The law is not yet thoroughly developed in this area, so it is possible that a creditor could successfully argue that an asset protection trust outside of Wisconsin should not protect the assets of a Wisconsin resident. However, it would most likely be a very difficult and expensive undertaking for a creditor to win that argument in court. This is why a trust can be beneficial even if it just makes it hard, even if not impossible, for a creditor to reach the trust's assets. In this same spirit, you could divide your assets among several asset protection trusts in several states, because it will be even more difficult for a creditor to pursue assets in numerous jurisdictions.

e. Estate Tax Benefits of Irrevocable Trusts.

In addition to the above discussed benefits of irrevocable trusts, there are estate tax benefits that can result from irrevocable trusts. Assuming the trusts are properly established, administered, and you survive a sufficient period of time after the trusts are funded, the assets in the trusts should not be subject to estate tax upon your death. Similar to the federal gift tax exemption, the federal estate tax exemption is also currently $5,000,000 per person, but is scheduled to be reduced to $1,000,000 per person in 2013 unless if the law is changed before then (as we expect). If it is likely that the value of your estate may exceed the federal estate tax exemption at the time of your death, the estate tax benefits of irrevocable trusts could be very attractive. (Note: the estate tax exemption available to your estate is reduced by the amount of gift tax exemption that you use during your lifetime.)

5. Limited Liability Companies ("LLCs").

LLCs can provide two different levels of asset protection.

a. **"Inside Liability Protection"** – If the ***LLC*** is sued, the person suing the LLC should only be able to reach the assets that are owned by the LLC. If the LLC was properly structured and maintained, your personal assets should not be available to satisfy the claims of the LLC's creditors.

b. **"Outside Liability Protection"** – If ***you*** are sued and you own an interest in an LLC, and if the LLC was properly structured and maintained, the person suing you should not be able to reach the assets within the LLC. Instead, the creditor should only be able to obtain a "charging order" against your interest in the LLC. A charging order assigns some of your rights in the LLC to the creditor. For example, if the LLC makes a distribution to you, the creditor would be entitled to that distribution. However, this may not be appealing to a creditor because if a charging order was obtained, the LLC's manager might choose to not make distributions (if this was allowed by the company's operating documents). In addition, an LLC's tax liability flows through to its members. As a result, if a creditor obtains a charging order, your share of the LLC's income tax liability will arguably flow through to the creditor, which can be a disincentive for a creditor to obtain a charging order against the LLC in the first place.[iv]

Each LLC should have more than one member because multiple member LLCs provide significantly more asset protection than single member LLCs.

LLCs can be combined with trusts by either (1) having an asset protection trust contribute funds to the LLC, or (2) gifting LLC units to the asset protection trust(s). Both approaches will result in the asset protection trust being a member of the LLC. This approach would provide two levels of protection, since the assets would be in an LLC, and the LLC units could be owned by an asset protection trust.

We also recommend that you have operating agreements prepared for each of your LLCs. We can add provisions to the LLC's operating agreements that maximize the creditor protection benefits of the LLC.

For an LLC to be respected by the courts, it is important that a valid business purpose can be established for its creation.

Finally, it is extremely important that proper business formalities be followed for each LLC in order to preserve the integrity of the business structure and its corresponding asset protection benefits. Creditor can “pierce the corporate veil” of an LLC if it is not administered properly. If the corporate veil is pierced, the owners of the company are held personally responsible for debts of the company.

Suggestions to make it difficult for a creditor to pierce the corporate veil include:

- Do not comingle personal assets with business assets.

- Retain sufficient assets outside of your businesses to support your standard of living.

- Verify that your LLCs are sufficiently capitalized. Adequate capitalization is measured by the nature and magnitude of the corporate undertaking at the time of the company's formation.

- Observe business formalities, such as hold annual meetings, maintain business records and minutes from meetings, execute consent resolutions for corporate decisions, issue dividends, keep corporate books and accountings, file annual tax returns, etc.

- Hold annual elections for Managers and observe the proper roles of the Manager and Members.

- Have Operating Agreements prepared for all of your LLCs and observe the provisions contained therein.

6. **Inheritance Planning.**

If you anticipate eventually receiving an inheritance from your parents’ estate, consider having your parents leave your inheritance to a trust for your benefit (which can be designed to be exempt from creditors), instead of leaving it to you outright (which would not be exempt from creditors). Your parents can either establish a trust for you to receive your inheritance under the terms of their estate plan, or, you can establish a trust for yourself that your parents can simply name in their estate plan as the beneficiary of your inheritance. In addition, the trust can be designed so that the inheritance is outside of your taxable estate, so that any assets remaining in that trust when you die are not subject to estate tax.

7. **Minimize Personal Guarantees.**

If you have personally guaranteed any loans, explore options to refinance with other banks that will not require personal guarantees.

8. **Liability Insurance.**

It is critical to maintain sufficient liability insurance to protect yourself in the event of creditor claims. If you own LLCs, they should be named as the insured or additional insureds on insurance policies that provide adequate coverage. If a traditional liability insurance policy is not adequate, umbrella liability insurance policies should also be considered. Although any LLC liability should be limited to the assets of that LLC, insurance coverage allows you to protect the assets within the LLC. For example, if someone slipped and fell on your property, we recommend maintaining sufficient insurance coverage to satisfy such a claim.

9. **College Savings Accounts.**

Wisconsin law also provides creditor protection to college savings accounts. You can open an account on behalf of any designated beneficiary. If the assets are not used for education, the funds can be withdrawn, however, it will be subject to tax and a penalty.

Conclusion

As the above indicates, there are many steps that can be taken to limit the ability of potential creditors to attach your assets without running afoul of the fraudulent conveyance doctrine. Please let us know if you are interested in receiving any additional information regarding the strategies discussed in this article. We would be happy to assist you with incorporating such strategies in your personal estate plan.

Please also note that there are numerous fact specific details, including gift tax, estate tax, generation skipping transfer tax and income tax consequences that could affect all of the above suggestions that need to be further considered before any of the above suggestions are implemented.

ENDNOTES:

[i] In bankruptcy, Individual Retirement Accounts receive creditor protection under federal bankruptcy law. Approximately $1 million of traditional and Roth IRAs assets are exempt from creditors in bankruptcy, and rollover IRAs (ERISA plans converted to Rollover IRAs) receive unlimited creditor protection in bankruptcy. However, this federal creditor protection for IRAs does not extend to non-bankruptcy situations. In the event of a creditor attack outside of bankruptcy, you must rely on state law for creditor protection for your IRAs.

[ii] "Owner-employee" means any individual who owns, directly or indirectly, the entire interest in an unincorporated trade or business, or 50% or more of the combined voting of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation, or 50% or more of the capital interest or profits interest of a partnership or limited liability company.

[iii] As an added benefit, if you survive the set period of years, the value of the residence will be outside of your estate for estate tax purposes upon your death. However, one trade off is that if you survive the period of years, the residence will not receive a step-up in basis for income tax purposes, which it would otherwise receive upon your death. This may result in additional capital gains taxes being due when the property is sold by your heirs after your death. In addition, favorable gift tax valuation rules that apply to remainder interests.

[iv] Depending upon the circumstances, commentators, academics, and practitioners disagree on whether a charging order should result in a debtor's share of an LLC's taxable income to flow through to the creditor holding the charging order. *THE CHARGING ORDER AND ESTATE PLANNING: AN OVERVIEW OF CHARGING ORDER PROTECTED ENTITIES AND THEIR POTENTIAL ROLE IN WEALTH PRESERVATION*, page 12, http://www.jeffreyburr.com/CM/Custom/Charging%20Order%20Article%2009-09-08.pdf.