Chapter 2 Asset Protection

2.1 The 10 Biggest Legal Mistakes Physicians Make Involving Asset Protection
By Daniel S. Rubin, Esq.

Executive Summary
All signs indicate that the prevalence of litigation against physicians is in a continuing upward spiral across the United States. Although some claims are meritorious, far too many are not. In such an atmosphere, every physician with even a modicum of wealth is subject to an unacceptable level of risk. Aggravating this problem is the fact that even in instances in which liability might, unfortunately, be clear, the extent of the injury and, by extension, the dollar amount of the damages, often remains subjective and can therefore be grossly inflated by an overzealous judge or jury. Timely and professional "asset protection" planning, free of the most common mistakes physicians often make, can help a physician to weather this litigation storm.

Mistake 1 **<u>Consulting Counsel Too Late</u>**
Once a claim has arisen, it is generally too late for a physician to protect his or her assets. This is because a transfer made with the intent to hinder, delay, or defraud a creditor will be held to be a "fraudulent transfer" and will be undone by a court. Moreover, the law of some states, such as New York, holds that a transfer made after a lawsuit has been brought is automatically deemed to have been made with the intent to hinder, delay, or defraud creditors. However, even transfers made prior to a lawsuit are at risk of being undone if the alleged act of malpractice has already occurred.

Action Step Physicians should consult with counsel to assess their asset protection options before those options are foreclosed by the existence of a claim.

Mistake 2 **<u>Hiring Inexperienced Counsel</u>**
For the same reasons that one should not rely on one's internist for medical issues that require a specialist's expertise, physicians should not expect every attorney to have the same level of asset protection planning skill. Asset protection planning, in particular, requires an in-depth understanding of the law that spans a number of legal disciplines, including trust law, real and personal property law, family law, bankruptcy law, and debtor-creditor law, as well as state and federal income, gift, estate, and generation-skipping transfer tax laws. Moreover, since asset protection often attempts to "cherry pick" the most favorable laws of domestic and even offshore jurisdictions, asset protection planning counsel should have a breadth of knowledge that goes beyond any one state or country.

Action Step Physicians should do their own due diligence before engaging counsel for asset protection planning advice. The attorney who assisted in establishing the physician's business practice is likely not the right choice to assist in establishing an asset protection plan. Physicians with asset protection plans already in place should consider obtaining a second opinion of the plan from independent counsel.

Mistake 3 Attempting to Protect Too Much

Courts will undo transfers made with the intent to "hinder, delay, or defraud creditors." Since few, if any, defendants will admit to such intent in creating a trust, transferring property to a spouse, or taking some other action that might protect assets from creditors, courts are forced to look for extrinsic evidence of such intent. To the extent that a physician has attempted to protect all of his or her assets, the courts will almost certainly find a fraudulent intent.

Action Step Physicians should remember the old adage, "Pigs get fat while hogs get slaughtered," and be satisfied with having obtained a reasonable level of asset protection. This concept is termed "nest egg" planning.

Mistake 4 Failing to Consider Life Insurance and Annuities

Although the issue is one of state law and therefore depends on a physician's residence, life insurance and annuities are two of a very limited class of investments that are generally protected against creditor claims. The public policy underlying such protection is grounded in the understanding that life insurance and annuities are essential for the debtor and his or her family to maintain at least a minimum level of financial well-being and thereby avoid becoming a burden to the state. The manner in which most state law is written, however, does not limit these protections to subsistence levels and even large dollar amounts can potentially be exempted from creditor claims.

Action Step Physicians should assess their asset holdings and determine whether life insurance and/or annuities should be integrated into their portfolios. Physicians are cautioned, however, to consult with planners who have experience in asset protection planning to ensure that the investment is properly structured to maximize its potential asset protection benefit.

Mistake 5 Failing to Update the Plan and/or to Get a Second Opinion

Asset protection is a moving target. Every year new statutes are enacted and new cases are decided that affect the planning environment in some manner. In addition, a physician's personal circumstances change over time in myriad ways that will affect the planning environment. To remain protected, it is incumbent upon the physician to remain abreast of changes that affect his or her asset protection plan.

Action Step Physicians should review their asset protection plan with counsel on a regular basis. Physician's counsel should endeavor to keep the physician informed as to legal

developments, and the physician should endeavor to keep counsel informed as to personal developments.

Mistake 6 **Retaining Too Much Control**
It is simple human nature to desire to control one's wealth, even after that wealth is "given away" for asset protection purposes. In asset protection planning, however, there exists an inverse relationship between the amount of control retained and the level of protection afforded. For example, a revocable living trust provides no asset protection because it is revocable by the settlor. Even irrevocable trusts can be successfully attacked, however, if excessive control is retained. A physician who establishes irrevocable trusts for asset protection purposes should strongly consider naming independent trustees and protectors, and should forego the option of funding the trust with any limited partnership, limited liability company, or corporation controlled by the physician. This is particularly true for "self-settled" asset protection trusts in which the settlor is also a trust beneficiary.

Action Step With regard to any self-settled asset protection trusts that the physician has created, the physician should resign as trustee and protector and should liquidate into the trust any underlying entity that the physician controls. Moreover, to the extent that a close friend or family member has been named in any of these capacities, he or she should be asked to resign in favor of an independent third party.

Mistake 7 **Relying Too Much on the "Charging Order" Remedy**
Family limited partnerships and family limited liability companies are often touted as sufficient to protect a physician's assets from creditors. The legal basis for such assertions is the "charging order" remedy, which provides that an owner's creditors cannot take the owner's interest in the entity, but instead are relegated to accepting distributions from the entity if and when distributions are made. To the extent that a family member or close friend is running the company, distributions are likely to cease until the claim is settled on terms favorable to the debtor.

Few state statutes provide that the charging order is an exclusive remedy, however, thereby making foreclosure of the physician's interest in the entity a real possibility. Moreover, even where the charging order is an exclusive remedy, most state laws require a "business purpose" for a valid limited partnership or limited liability company to exist, and pure "asset protection" might not be deemed a valid business purpose.

Action Step Physicians who have family limited partnerships or limited liability companies should review them to determine the state law under which they were established. If established under the law of the physician's residence, the physician should question whether his or her state coincidentally happens to have the best legislation in this regard or

whether the physician obtained inadequate legal advice. In the latter case, the physician should consider relocating the entity to a more favorable jurisdiction.

Mistake 8 **Owning Real Estate Improperly**

Residential real estate is exempted from the claims of most types of creditors if owned by a husband and wife in a form of joint tenancy called a "tenancy by the entireties." The basis for the protection is that one spouse's interest in the property should not be subject to creditor claims attributable solely to the acts of the other spouse. This protection can, however, be lost in the event of the death of the nondebtor spouse or in the event of a divorce, or where the creditor is a joint creditor of the husband and of the wife.

Commercial real estate should be owned within a limited liability company (an LLC). Like a corporation, an LLC insulates the owners of the company from liabilities arising out of the company's business (i.e., the rental of real estate), but is better than a corporation for several reasons. First, unlike a corporation, an ownership interest in an LLC is arguably subject to charging order protection and, therefore, an owner's creditor are not automatically entitled to control or liquidate the company. Second, unlike a corporation, there are few administrative formalities required of an LLC. Finally, unlike certain types of corporations, LLCs pass through all incidents of taxation to their owners, thereby avoiding significant tax complexity and the potential for a second level of taxation.

Action Step Married physicians should review the deed to any residential real estate to ensure that the deed reflects ownership by the physician and the physician's spouse as tenants by the entirety. Physicians should ensure that any commercial real estate that they own be transferred to a properly structured LLC; where the commercial real estate is currently owned by a corporation or a partnership, the physician should consider converting the entity to an LLC.

Mistake 9 **Underfunding Pension Plans and Individual Retirement Accounts**

Pension plans that are "qualified" plans under the Employee Retirement Income Security Act of 1979 (ERISA) have been held by the U.S. Supreme Court to be protected from creditor claims. Individual retirement accounts (IRAs) are protected from creditor claims under the laws of some, but by no means all, states. Moreover, even those states that exempt IRAs from creditor claims may not exempt Roth IRAs, since Roth IRAs are created under a different section of the Internal Revenue Code. Physicians should, therefore, be careful when deciding whether to "roll out" a pension plan into an IRA, since doing so may negate the asset's innate protection.

Action Step Physicians should ensure that they are fully funding their pension plans, as well as their IRAs, since such assets likely provide protection from creditor claims (as well as a significant financial benefit due to the ability to obtain tax-deferred growth).

ASSET PROTECTION: OVERVIEW

Mistake 10 **Relying on "I Love You" Wills**
When a person dies survived by a spouse, no estate tax will be due. This is because an unlimited deduction exists for property that is left to a surviving spouse whether outright or trust. Due to the perceived complexity of trusts, an individual who is ill advised will often choose an outright disposition of his or her estate to the spouse, and vice versa. Individuals who are well advised will always choose to use a trust; not for any tax benefit, but because creditors are barred from satisfying their claims against monies left in trust. This is true ever though the surviving spouse might have broad access to the trust fund.

This planning is especially important for physicians, since they often employ "poor man's asset protection planning" by titling assets in the name of their spouse. In such a case, if the spouse should die first, that type of planning is undone, since the assets will come back to th physician unless a trust is used.

Action Step Physicians should review their last will and testament and that of their spouse. If it provides that any portion of the estate passes to the surviving spouse outright, it should be redrafted to include a qualified terminable interest property (QTIP) trust.

Conclusion
Physicians need not remain at risk to the possibility of a devastating malpractice claim. Timely asset protection planning, with the assistance of competent counsel and which is regularly reviewed, can reduce a physician's risk to a manageable level.

About the Author
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Chapter 12 Estate Planning

12.1 The 10 Biggest Legal Mistakes Physicians Make Involving Trusts
By Daniel S. Rubin, Esq.

Executive Summary
From "insurance trusts" to "intentionally defective grantor trusts," trusts are becoming more ubiquitous in estate planning. The two major reasons for the increasing use of trusts in estate planning is the fact that trusts can provide a mechanism for saving estate taxes at death, as well as a mechanism for avoiding potential future creditors. Trusts are, however, intricate legal relationships in which pitfalls abound, and physicians must take care in establishing and administering their trusts in order to avoid potentially serious mistakes.

Mistake 1 **Failing to Consider Grantor Trust Status**
The tax law provides for three basic types of trusts: simple trusts, complex trusts, and grantor trusts. Simple trusts require all income to be paid out to the trust beneficiaries and, as a consequence, the beneficiaries rather than the trust will be taxed on the trust's income. Complex trusts do not require that all income be paid out to the trust beneficiaries and, as a consequence, the beneficiaries will be taxed on trust income that is distributed to them and the trust will be taxed on trust income that remains undistributed. In grantor trusts, the grantor retains certain set powers that have the effect of causing the trust income to be taxed to the grantor, whether or not it is distributed or retained in trust. Although it would appear that grantor trust status should be avoided, if the physician has the ability to pay the tax, grantor trust status actually permits the equivalent of tax-free growth for the trust fund.

Action Step Physicians who are establishing trusts in order that the property might grow and not be included in the physician's estate when he or she dies should consider the powerful opportunities afforded by having the trust drafted as a grantor trust. In order that the obligation to pay tax on the trust's income never becomes a burden, however, physicians should consider having the trust drafted so that the grantor trust status can be turned on and off and so that the grantor can be reimbursed for taxes payable on the trust's income, if necessary.

Mistake 2 **Administering the Trust Improperly**
A trust is an agreement between the settlor and the trustee regarding the administration of property for the benefit of identified beneficiaries. Like a contract, a trust's terms must be respected or else certain adverse consequences are likely. From the settlor's perspective, if the trust is administered improperly, in contravention of its terms, any tax benefit will likely be lost. For example, if the Internal Revenue Service determines that there was a prearranged plan between the settlor and the trustee such that the trustee's "discretion" to make

distributions would be exercised only upon the settlor's "request," the trust property will be deemed includible in the settlor's estate. A similar result would occur if a trustee that is also a beneficiary of the trust is found to have exceeded its permissible discretion to distribute property for the "health, education, maintenance, or support" of a beneficiary. From a trustee's perspective, a breach of the trust agreement, no matter how small or seemingly innocuous, has the potential to expose the trustee to liability to the beneficiaries if a financial loss should result.

Action Step Physicians should carefully review the terms of all trust agreements in which they are involved in any manner to ascertain and understand their terms. Physicians should also request from the attorney who drafted each trust a written statement setting forth the manner in which the trust is to be administered.

Mistake 3 **Not Using a Qualified Personal Residence Trust**

Like most Americans, the single most valuable asset of most physicians is often their home. A little known form of trust called a "qualified personal residence trust" (QPRT) can remove the value of the home, together with any future appreciation on it, from the owner's taxable estate at little gift tax cost. Many physicians, however, fail to even consider using a QPRT because of emotional issues that exist in connection with a person's home. Yet, the QPRT is one of a very few estate planning techniques that has the potential to significantly reduce estate taxes without unduly affecting the way the settlor lives.

The concept of the QPRT is simple: A homeowner transfers his or her home into trust but retains all right to its use and enjoyment for a set term of years. The "remainder" beneficiaries (e.g., the homeowner's children) do not have any rights under the trust until the expiration of the set term of years; therefore, the value of the gift is the discounted value of the receipt of the gift many years in the future.

An example illustrates the power of the QPRT. Assume that in May 2004, a 40-year-old settlor transfers a $1 million home to a QPRT with a 35-year term. The settlor will be charged with having made a gift of slightly under $172,000. If the settlor survives the 35-year term, the home (then worth almost $4 million if a 4% rate of growth is assumed) will not be taxable as a part of the settlor's estate. The only caveat is that the settlor must survive the term of years that he or she chooses or else the transaction is unwound for tax purposes.

Following the expiration of the initial 35-year term, the settlor would still have the right to use the residence as the settlor's home, but would pay fair market rent to the QPRT for that privilege; thereby transferring even more money to the intended beneficiaries without tax effect (because the QPRT can be structured as a grantor trust both during and after the initial term of years). It is for this reason that all of the benefits incident to home ownership (e.g.,

mortgage interest deduction, real estate tax deduction, capital gains exclusion) are retained as well.

Action Step Physicians who own a home and are likely to have a taxable estate when they die should create a QPRT.

Mistake 4 **Naming Inappropriate Fiduciaries**

Perhaps the most important question that must be answered when creating a trust is whom to name as the trustee. A close friend or family member is often the first choice because of the belief that such a person will accede to the settlor's wishes in exercising trustee discretion in the trust's administration. The choice of a close friend or family member as a trustee also has the benefit of keeping costs down, since such persons rarely take commissions for acting as trustee. In contrast, corporate trustees, such as banks or trust companies, will not necessarily accede to the settlor's wishes under all circumstances and will certainly charge their regular commission schedule for acting as trustee. In exchange for its fee, however, a corporate trustee will provide professional tax and investment services to the trust. Moreover, an individual trustee is much more likely to misappropriate from the trust than is a corporate trustee.

Action Step Physicians should carefully consider whom to name as trustee. Relationships with individuals, even family members or close friends, are subject to change, and individual trustees are subject to the possibility of malfeasance in myriad ways that are unlikely to occur with a corporate trustee. Physicians should consider a compromise solution of naming an individual trustee during the physician settlor's life and a corporate trustee thereafter.

Mistake 5 **Keeping the Trust Local**

Businesses throughout the United States incorporate in the state of Delaware in order to obtain the benefits of Delaware's corporate law. This type of forum shopping is also available to individuals who wish to "cherry pick" the trust and tax law applicable to their trust, since the law provides that the administration of a trust is to be governed by the law chosen by the settlor as may be set forth in the trust agreement.

There are a number of significant considerations in choosing what state's law should govern a trust. One is whether the state has repealed the "rule against perpetuities," which mandates that a trust terminate within a certain set period of time. Another is whether the state imposes a state-level income tax on trust income. For many physicians, one of the most important considerations is whether the physician can also be a discretionary beneficiary of a self-created trust without having the trust remain subject to the settlor's creditors during life and the estate tax at death.

Action Step Physicians should carefully consider their goals when establishing a trust and attempt to coordinate those goals with the vagaries of different state laws. This coordination is best done with the assistance of a competent trust lawyer. Trusts that have already been established but that do not meet all of a physician's goals may contain a "change of situs" clause enabling the trust to relocate to a more appropriate jurisdiction. If a trust does not contain a change of situs clause, and the state law currently governing the trust is inappropriate, a court proceeding might enable the trust to move to another state.

Mistake 6 **<u>Tying the Hands of the Trustee</u>**
A trust agreement can be drafted to give the trustee broad discretion, limited discretion, or no discretion. Trusts are often drafted, generally without much forethought, in a manner that limits the trustee's discretion. This is often later found to be a mistake, since no one knows what the future might hold and the very concept of a trustee is someone the settlor deems trustworthy to make the decisions that the settlor would make under similar circumstances.

For example, a trustee's discretion to make distributions to a surviving spouse might be limited to trust income rather than trust income and/or principal. While, in general, income might be sufficient for a surviving spouse's maintenance, returns on investment might fall or the surviving spouse may come to have increased health care costs or other special needs for which the trust income might ultimately prove insufficient.

Action Step A physician setting up a trust should pick an appropriate (read "trustworthy") trustee and then have the trust drafted to provide that trustee with the broadest possible discretion.

Mistake 7 **<u>Failing to Fund Revocable Living Trusts</u>**
In many states, probate (i.e., the process by which a last will and testament is validated by the court) is relatively quick and fairly inexpensive. Moreover, unless the decedent happened to be a celebrity, the fact that probate creates a public record is of little consequence. In other states, where probate is more time-consuming, complicated, and expensive, individuals who are well advised will create a revocable living trust as a will substitute in order to avoid the process entirely. Significantly, however, the creation of a revocable living trust does not avoid probate unless the trust is also funded, during life, with all of the settlor's assets (other than jointly owned assets or assets, like life insurance, that pass by operation of law). In fact, if even a small bank account, brokerage account, or other asset has been left outside of the revocable living trust, a probate proceeding will be required.

Action Step Physicians who have revocable living trusts as a will substitute should ensure that all of their assets are properly titled in trust as soon as possible.

ESTATE PLANNING: TRUSTS

Mistake 8 **<u>Leaving Property Outright to One's Spouse</u>**
In a properly drafted last will and testament, because of an unlimited marital deduction against the value of property left to a surviving spouse, there generally will be no estate tax upon the death of the first spouse to die. This unlimited marital deduction applies whether the property is left to the surviving spouse outright or in a special type of trust called a "qualified terminable interest property" (QTIP) trust. Inasmuch as the tax result will not differ, people commonly leave a large portion of their estate to their spouse outright even though a marital trust would be preferable for several reasons:

- Property left in a marital trust will be protected from the surviving spouse's creditors.
- Property left in a marital trust will be protected if the surviving spouse remarries and later divorces.
- Property left in a marital trust will be protected from a "right of election." More specifically, if the surviving spouse remarries and then predeceases his or her new husband or wife, that person will have the right to elect to take a third or more of the deceased spouse's estate, irrespective of what the surviving spouse's last will and testament might say. Since a marital trust is not considered a part of the surviving spouse's estate for this purpose, however, it is protected from any right of election.
- The use of a marital trust ensures that to the extent that the trust is not exhausted in providing for the surviving spouse, any remaining property will pass to the children of the marriage (or the deceased spouse's other intended beneficiaries, as the case may be), upon the surviving spouse's death.

Action Step Physicians should review their last will and testament (or revocable living trust) to determine whether property passing to the surviving spouse passes outright or in trust. If outright, the physician should speak with his or her spouse to see if the spouse can agree that the use of marital trusts better serves their respective interests.

Mistake 9 **<u>Not Transferring Insurance Policies Into an "Insurance" Trust</u>**
Most physicians with even a modicum of financial sophistication know that a life insurance policy death benefit is received free from income tax. A much smaller number of physicians know that life insurance is not also received free from estate tax. Under current law, the death benefit can be reduced by almost one half due to estate taxation if no planning is done. The recommended planning, in most cases, is an irrevocable "insurance" trust.

Unlike other types of trusts, insurance trusts generally require that gifts be made to the trust every year so that premiums can be paid. Unfortunately, the $11,000 per beneficiary "annual exclusion" from gift tax does not apply to gifts to a trust unless the beneficiaries have the right to withdraw the gifted amount (called "Crummey" withdrawal rights). It is not enough, however, that this right be drafted into the trust agreement; for the Internal Revenue Service to actually respect the existence of these powers, certain procedures must be followed. First, the trustee needs to provide notice to the beneficiaries each time a contribution is made.

Second, in order to give the beneficiaries the practical ability to exercise their withdrawal rights, if they should so choose, the contribution should be held by the trustee for some period of time before being used to pay premiums. Finally, the beneficiary should be made to sign a statement acknowledging receipt of the notice, and the notice and the receipt should be retained with the trust records to protect against the possibility of a later estate tax audit.

Action Step Physicians should ensure that these procedures are followed so that the existence of Crummey powers will be respected by the IRS and, therefore, that their gifts to the insurance trust will be excluded from gift tax.

Mistake 10 **Keeping the Good News to Themselves**
The law of every state provides that the assets of a "spendthrift" trust are unavailable to a beneficiary's creditors. This holds true irrespective of how broadly the trustee might choose to exercise its discretion to benefit the beneficiary from the trust fund. The major limitation in the use of spendthrift trusts in this regard is the fact that only six states permit an individual to transfer property to a trust for his or her own benefit and yet have it protected from potential future creditors.

Some individuals, however, will receive an inheritance when their parents, aunts, uncles, or other family members die. If the inheritance is left outright, it will be exposed to existing creditors and will likely remain exposed to potential future creditors. Moreover, to the extent that the inheritance is not ultimately consumed, it will likely be hit with an estate tax when the recipient of the inheritance eventually dies. An inheritance received in trust will be unavailable to creditors and free from future estate tax and is therefore infinitely preferable so long as a friendly trustee is given broad discretion to make distributions to the beneficiary.

Action Step Physicians should speak with any one who might leave them an inheritance to suggest that it be left in trust rather than outright. Physicians should also suggest whom they would like to see named as the trustee.

Conclusion
Physicians should freely employ trusts in their estate planning for the many benefits that trusts can provide. They should exercise care, however, to ensure that their trusts are first drafted and then administered in a manner that ensures that those benefits are actually obtained.

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