

DISTRICT OF COLUMBIA BAR
Continuing Legal Education

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What Every Estate Planner Should Know
About Asset Protection

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1. Fraudulent Transfers, CAVEAT!!

Most asset protection techniques involve the transfer of assets from a relatively more risky or vulnerable location to safer, more protected holdings. However, transferring assets in order to avoid existing creditors, may be avoided as a fraudulent transfer.

A. General: Many states have developed fraudulent transfer statutes, but some still rely on the common law. Many states have adopted the Uniform Fraudulent Transfer Act (UFTA) which attempts to provide some uniformity.

B. District of Columbia: The District has adopted the UFTA at D.C. Code Ann. § 28-3104 et. seq.

C. Maryland: Maryland retains the predecessor of the UFTA, the Uniform Fraudulent Conveyance Act (UFCA), codified in the Maryland Code at Title 15 Debt Collection- Special Provisions, Subchapter 2 §15-201 et. seq. See also Nissen Corp. v. Miller, Md. 613, 594 A.2d 564 (Md. App. 1990) (applying the UFCA).

D. **Virginia:** Virginia has not adopted the UFTA, and continues to utilize its own statute, codified at Va. Code Ann. §§ 55-80 which follows the common law requirement to prove actual fraud.

E. **Bankruptcy:** 11 USC § 548 of the Bankruptcy Code provides its own criteria and remedy for a fraudulent transfer based upon the UFTA.

F. **Void and voidable** transfers that violate the specific provisions of the UFTA, state common law, or the bankruptcy code may be avoided by the courts. Transfers that are “void” are invalid from the outset or the moment the transfer is made, while “voidable” transfers are invalid only if they are subsequently declared as such by one of the parties or the court. This distinction is not clearly understood or consistently applied by the courts. Within the law of fraudulent transfers, the improper transfers are usually treated as voidable which provides planning opportunities.

G. **Statutes of limitations:** Claims regarding fraudulent conveyances must be brought within the applicable statute of limitations or else risk being dismissed.

i) **District of Columbia-** Four (4) years from the date of the conveyance, or within one year of the time a creditor should have known of the conveyance. See D.C. Code Ann. § 28-3109.

ii) **Maryland:** Maryland has a general three (3) year statute of limitations. Md. Code Courts and Judicial Proceedings §5-101.

iii) **Virginia:** Va. Code Ann. § 8.01-243 requires actions alleging fraud be filed two (2) years from the alleged fraudulent conveyance, or if “fraud, concealment or intentional misrepresentation prevented discovery of the injury within the two-year period”, then one year from the date of discovery.

iv) **Bankruptcy:** Chapter 7, 12, and 13 cases require creditors to file claims within 90 days of the date of the first meeting of creditors. Thereafter, 11 U.S.C. §546(a)(1) provides that a Trustee may not bring an action for fraudulent conveyance after the later of; (A) more than 2 years after the entry of order for

relief; (B) more than 1 year after appointment of the trustee, or (C) after the case is closed or dismissed.

2. Basics

A. ERISA Qualified Retirement Investments: The Employee Retirement Income Security Act of 1974 (ERISA) amended the IRS Code to provide employers a means to deduct annual allowable contributions for each participant. These deductions are tax-deferred until withdrawn and come in one of two basic types: Defined benefit plans (including pensions and annuities) and defined contribution plans (including profit sharing, Individual Retirement Accounts (IRAs), 401(k) plans, stock bonus plans, money purchase pension plans, target benefit plan, and cash-balance plans). 29 U.S.C. §1056(d)(1) of the ERISA law protects these retirement funds from creditors of the employee with its anti alienation clause except the IRAs.

The Supreme Court has held that alienation provisions in a beneficiary/debtor's interests in a qualified retirement plan trust are enforceable. Consequently, the Court held, a debtor's interest in an ERISA-qualified plan can be excluded from the property of the bankruptcy estate. Thus, ERISA qualified-plan assets cannot be reached in a bankruptcy proceeding when valid anti alienation provisions prohibit creditors from reaching assets. This protection extends to I.R.C. § 457 deferred compensation plans of state or local governments, and to federal civil service retirement benefit plans and also applies in non bankruptcy debt collection proceedings.¹

A different result occurs for nonqualified plans and for individual retirement accounts (IRAs) for which ERISA does not mandate an anti-alienation provision. Specifically, such plans do become part of the bankruptcy estate because they do not contain an ERISA-mandated anti-alienation provision. Moreover, planners should note that small ERISA-qualified plans in which only the client and his spouse participate may be considered nonqualified plans and subject to attack by creditors.²

¹ Patterson v. Shumate, 504 U.S. 753 (1992)

² Id. at 762-63.

When clients roll over their qualified plan benefits into individual retirement accounts or other nonqualified plans, they lose the protection accorded such ERISA-qualified plans under federal protection. Some states have taken steps to protect IRAs and avoid this result.³

Even qualified plans do not protect assets from tax claims or claims of the client's spouse, children, or other dependents, who may obtain a qualified domestic relations order to reach plan assets⁴.

In the non bankruptcy context, ERISA preempts state law⁵. Therefore, clients' interests in qualified plans are generally protected from their creditors' reach⁶.

B. Homestead Exemptions: A safe-haven for **some value of a residence and possibly all of it**, Homestead exemptions exist in all three local jurisdictions in various amounts.

i) **District of Columbia:** The District of Columbia allows an unlimited homestead exemption for a debtor's actual residence. D.C. Code § 15-501.

ii) **Maryland:** Maryland, through various exemptions, will allow exemptions up to \$11,000. Md. Code Ann. [Cts. & Jud. Proc.], § 11-504 and 507.

iii) **Virginia:** Virginia exempts a value up to \$10,000 for any property. Va. Code Ann. §§ 34-4 and 18.

iv) **Bankruptcy:** The federal bankruptcy exemption does not apply in Maryland or Virginia because those states have “opted out” of the federal exemptions and use only their state exemptions laws. However, DC residents may use either federal or DC exemption laws. If DC exemption law is used, the residence must have been held for 1215 days prior to the filing of the petition in order to get the 100% exemption. Otherwise,

³ Id.

⁴ ERISA § 401(a) (13)(B)

⁵ Atena Health Inc. v. Davila, 542 U.S. 200 (2004).

⁶ Id.

the lesser amount of the federal bankruptcy exemption will apply. (In 2008 that amount is \$136,875).

C. Tenancy by the Entirety: An estate in property (usually real property, but it may be personal property) closely resembling joint tenancy with rights of survivorship. This estate can exist only between a husband and wife. It places title jointly in the names of the husband and wife, and provides for rights of survivorship. An important aspect of this estate is that property so titled is generally unavailable to creditors having claims against only one of the spouses. In Maryland, Virginia, and D.C. a divorce causes a tenancy by the entirety to become a tenancy in common. However, there is some anomalous case law in D.C. that provides for the holding by tenancy-by-the-entirety property even after a divorce. However, it is doubtful that this would still be valid if tested.

NOTE that in US v. Craft, 535 US 274 (2002) the US Supreme Court held that the IRS could sell a T by E held property even though the other spouse did not owe the tax. The trustee in bankruptcy may do the same as T by E property may be property of the estate. See 11 USC §541(a)(2).

DC requires that the T by E be clearly stated⁷ while Maryland⁸ and Virginia⁹ will allow the T by E status if the deed only states “x and y as husband and wife” or “X and Y, a married couple.”

i) **Real Estate:** Real estate is the most traditional asset to be held as a tenancy by the entirety. Married couples purchasing property must ensure that the deed conveying the property specifically creates the desired estate through granting language that is unambiguous.

ii) **Personal Property:** Titling personal property as tenants by the entirety is also allowable in Virginia (Va. Code Ann. §55-2-2(B)),

⁷ See *Coleman v. Jackson*, 109 U.S. App. D.C. 242, 286 F.2d 98 n.8 (D.C. App. 1960); D.C. Code Ann § 42-516 (2001).

⁸ In Maryland, courts have held that intent to create a tenancy in common can be inferred from more general language. *Diamond v. Diamond*, 298 Md. 24, 31-32, 467 A.2d 510, 514 (Md. App. 1982) (noting that courts may properly presume intent in cases of real estate purchases made by a husband and wife.)

⁹ *Kerr v. Dill*, 72 Va. Cir. 148 (Va. Cir. 2006) (holding that as long as a note indicates the marital relationship of the parties, an intent to create a tenancy by the entirety can be assumed).

Maryland¹⁰ (MD Code Estates and Trusts §16-102), and the District of Columbia. D.C. Code Ann. § 19-602 (relating to bank accounts).

iii) **Bank Accounts**¹¹: The problem with institutional accounts is the printed form presented by the account executives. Tenancy by the entirety is rarely an available selection. The account cards and the computer systems usually do not include tenancy by the entirety as an option. Joint tenancy with right of survivorship is normally available, but this does not automatically confer the protection afforded by a tenancy by the entirety. If screaming or pleading with the account officer is not productive, at least try to add "husband and wife" after the names on the account to give rise to an inference that that the account is held as tenants by the entirety.

D.C., Virginia, and Maryland all have statutes that protect banks holding joint accounts. These statutes allow a banking institution to pay out a joint account to either party with impunity, but they do not determine the parties' interest as to outside creditors.

In all three jurisdictions, bank accounts, security accounts, and certificates of deposit may all be titled as tenancy by the entirety if the institution will allow you to do so. There is no statutory bar to the creation of such an account, and, as mentioned above, there is statutory recognition of tenancy by the entirety in personal property in all three jurisdictions.

The case law in Maryland, if followed as to bank accounts, should create tenancy-by-the-entirety status in a bank account if the parties are husband and wife, provided they manifest the required *intent* to create such an account¹². D.C. and Virginia have both recognized tenancy-by-the-entirety bank accounts where the funds on deposit were sales proceeds from real property that was held as a tenancy-by-the-entirety. However, the law is ambiguous enough in all three jurisdictions that there is no substitute for clearly expressing the clear intent to hold the account as tenants by the entirety.¹³

NOTE that under certain conditions a bankruptcy trustee may partition the T by E property even if only one of the spouses is the debtor

¹⁰ *Diamond v. Diamond*, 298 Md. 24 (Md. App. 1982) (citing numerous cases for the proposition that personal property can be held by the entirety).

¹¹ <http://www.pearlstein-law.com/asset.html>

¹² *Jones v. Jones*, 259 Md. 336, 270 A.2d 126 (1970) (clarifying that the *intent* of the parties controls when determining whether a tenancy by the entirety exists)

¹³ <http://www.pearlstein-law.com/asset.html>

that filed. 11 U.S.C. § 541(a)(2). As previously noted above, US v. Craft authorized the IRS to sell T by E property though the other spouse does not owe the tax.

iv) **Tenants by the Entirety Property in Revocable Trusts:**

a) **The District of Columbia:** Both real and personal property may be held as tenants by the entirety.¹⁴ Despite logic and strong argument, there is no specific authority to indicate that the T by E status and protection against creditors of one spouse would continue if transferred to a revocable trust for one or both spouses. .

b) **Maryland:** As in the District of Columbia, without any clear statute or case authority, most practitioners believe that asset protection is lost if transferred to a revocable trust.¹⁵ .

c) **Virginia:** A 2008 statute, allows couples to transfer T by E property to a revocable trust without sacrificing any of the protections afforded by the T by E estate (Va. Code Ann. § 55-20.2.)¹⁶

D) **Corporations**

A basic characteristic of all corporations provide limited liability protection to the shareholders (owners). The shareholders liability is limited to their cost for the stock they purchases. There are a number of different corporate forms:

i) **S Corps-** An “S Corp” is a corporate entity taxed under subchapter S of Chapter 1 of the IRS Code. The hallmark of an S Corp is that the corporation does not pay income tax. Rather, the corporation's income or losses are divided among and passed through to its shareholders.

¹⁴ In re Estate of Wall, 440 F. 2d 215 (D.C. App 1971), & Finley v. Thomas, 691 A. 2d 1163 (D.C. App. 1997). See also D.C. Code §42-516(a).

¹⁵ But see: Maryland National Bank v. Peara, 329 Md. 602, 620 A. 2d 941 (Md. 1993) and <http://www.registers.state.md.us/html/livingtrusts.html>

¹⁶ Pitts v. United States, 242 Va. 254, 408 S.E. 2d 901 (1991); Sulzman v. Banick, 62 Va. Cir 139 (2003) & Dill v. Kerr & Associates, ____ Va. Cir 27 (2003).

The shareholders must then report the income or loss on their own individual income tax returns.

ii) **C Corps-** The more traditional form of incorporation. Unlike the above S Corp, a C Corp profits and income are subject to taxation.

iii) **Not for profits-** A not-for-profit (or non profit) entity is an incorporated entity or an unincorporated association created by statute, governmental or judicial authority. Not for profit corporations may obtain tax exemption status by applying to the IRS and /or their state government. The personal liability of the officers, directors, members and volunteers may be specifically limited as in DC Code §§29-301.113 and 971.06.

iv) **Limited Liability Corporations-** The IRS describes an LLC as follows: “similar to a corporation, owners have limited personal liability for the debts and actions of the LLC. Other features of LLCs are more like a partnership, providing management flexibility and the benefit of pass-through taxation. Owners of an LLC are called members. Since most states do not restrict ownership, members may include individuals, corporations, other LLCs and foreign entities. There is no maximum number of members. Most states also permit “single member” LLCs, those having only one owner. A few types of businesses generally cannot be LLCs, such as banks and insurance companies. Check your state’s requirements and the federal tax regulations for further information. There are special rules for foreign LLCs.”

a) **LLC Series-** A specific type of LLC, a Series LLC is designed to compartmentalize liability through the creation of multiple LLC entities, each with distinct assets. The advantage lies in allowing for riskier assets to be held separate from “safer” or less risky property by different limited liability entities, but each being owned by a single LLC parent.

The hallmark of the Series LLC is its conservation of effort and maximization of asset protection utility. By insulating each entity without forcing the owner to create new corporate structures out of whole cloth, the Series LLC provides asset protection by segregating assets while maintaining control in a single limited liability entity¹⁷.

¹⁷ Niemann, T.M. & Madison, M.S. [The Series LLC: new Illinois law provides avenue for asset protection.](#) Illinois Bar Association. Real Property. November 2005. Vol. 51, No. 2.

NOTE: The commingling of the assets and use of the same books may give rise to a claim against the assets of the entire Series.¹⁸

v) **Fiduciary Liability of Officers and Directors-** Generally, individual officers and directors are not personally liable for the debts of their corporations. The business judgment rule affords these corporate officers and directors with a strong presumption that their decisions were in the best interest of the corporation¹⁹. Officers and directors each owe the corporation and its shareholders duties of good faith, loyalty, and honesty.²⁰

Creditors may seek to hold these company officials personally liable, but will generally be required to show gross negligence or extreme malfeasance to overcome the presumption of the business judgment rule.²¹

vi) **Zone of Insolvency-** This refers to the time period when a company operates while under severe financial difficulty. During this period, corporate directors continue to owe their shareholders a fiduciary duty, but do not yet owe this duty to creditors. North American Catholic Educ. Programming Found., Inc. v. Gheewalla, 2007 WL 1453705 (Del. May 18, 2007) unless they are guilty of negligence or an intentional breach of their fiduciary duties.

However, some cases hold that operators and directors may be personally liable to the creditors of the corporation for breach of fiduciary duties. In Virginia, courts have held that company operators begin to owe a fiduciary responsibility to creditors during the zone of insolvency.²² However, the Virginia courts adopt the majority position and would not recognize an independent cause of action in tort for operating during a deepening insolvency to the harm of creditors.

E. Partnerships

¹⁸ 18 Am. Jur. 2d Corporations § 47; Terry v. Meredith, 357 B.R. 374, 380 (E.D. Va. 2006) (pointing out that the corporate veil should be pierced only if the assets are comingled or the corporate form is disregarded).

¹⁹ Willens v. Wisconsin Ave. Coop. Assn., 844 A.2d 1126, 1136 (D.C. App. 2004).

²⁰ Ill. Jur Business Relationships § 7:42

²¹ 18 Am Jur 2d Corporations § 47

²² Schmelling v. Crawford (In re James River Coat Co.), 360 B.R. 139, 170 (E.D. Va 2007); Poth v. Russey, 281 F. Supp. 2d 814, 826 (E.D. Va 2003)

i) **Limited Liability Partnerships**- Sharing many of the characteristics of a LLC, a Limited Liability Partnership (LLP) is preferred by some professionals because of its ability to shield partners from malpractice liability attributable to other partners. The specifics of the LLP are governed by the partnership agreement and the liability protection is enabled and provided by state statute.

ii) **Limited Partnerships**- A form of limited liability that consists of a General Partner (or partners) and limited partners. The general partner is responsible for governing all assets of the partnership, and is personally liable for debts of the partnership. The limited partners, by contrast, have no sway over the daily activities of the partnership but are protected from any personal liability as a result of actions of the partnership except for the cost of the limited partnership.

iii) **Family Limited Partnerships (FLP)**- This is a limited partnership formed to hold the family business or investments. Although not recognized by statute, the intent of these partnerships is for parents to gift their interest in this business to their children. Another desirable feature of the FLP is its status as a Charging Order Protected Entity (COPE). As a COPE, the FLP members are protected against outside creditors obtaining a charging order (similar to a business garnishment against the assets of a partnership) against a partner's right to distributions from the FLP.

3. Exemptions During Life

A. **States (DC, MD & VA)**- The federal government and every state exempt certain types of property from the reach of creditors. Some of the most important exemptions are the following: homestead exemption; life insurance; ERISA-qualified retirement benefit plans; individual retirement accounts and certain other nonqualified plans; and proceeds from personal injury claims. A chart identifying most of these exemptions for our 3 jurisdictions is attached as Appendix A.

B. **Bankruptcy**- Providing one of the most powerful asset protection tools available to debtors. Secured debt may be reclassified as wholly or

partially unsecured, terms may be altered and extended, payments reduced and debt discharged. Bankruptcy exemptions can protect assets such as a home, tools of the trade, car, life insurance and pension benefits. 11 U.S.C. § 522 enumerates specific exemptions for bankrupt debtors under the Federal bankruptcy rules, and these exemptions are complimented by varying State provisions (§ 15-501 of the DC Code; § 11-504 of the Maryland Code; and VA Code §§ 34-26 et. seq.; 34-4).

Because all of the states have remarkably different exemption laws, the Bankruptcy Code exemption section could only gain political acceptance if each state was given the right to “opt out” of the federal bankruptcy exemptions. In this region, Virginia and Maryland have opted out and only their smaller state exemptions may be used by a debtor in those states. In D.C., there was no opt out and so a local debtor may use either the local exemption law or the federal bankruptcy laws.

Because the federal bankruptcy exemptions were so much more generous prior to D.C. Code § 15-501, most debtors in D.C. chose to use the federal exemptions unless they were trying to protect tenancy by the entirety property with equity. The reason being that a bankruptcy trustee may partition tenancy by the entirety property as part of the bankruptcy estate (11 U.S.C. § 341(a)(2)(B)) if the bankruptcy exemptions are used. But the Trustee may not partition the tenancy by the entirety asset if the D.C. exemptions are used. However, the Trustee may still liquidate tenancy by the entirety property for the benefit of creditors of both spouses whichever exemption law is used²³.

4. Exemptions After Death

A. Homestead Allowances in Probate Estates

i) **District of Columbia-** D.C. Beneficiaries are entitled to a homestead allowance of up to \$15,000, payable out of the personal estate of the decedent²⁴.

ii) **Maryland-** Maryland does not provide for any homestead allowance as such.

²³ <http://www.pearlstein-law.com/exemptions.html>

²⁴ D.C. Code Ann. §19-101.02

iii) Virginia- The surviving spouse or minor children are also entitled to up to \$15,000 in addition to the family allowance and exempt property allowances described in this section. However, this \$15,000 is in lieu of any share passing by will, unless that share is less than \$15,000²⁵.

NOTE: If the surviving spouse claims and receives an elective share of the decedent's estate under Va. Code Ann. §§ [64.1-13](#) through [64.1-16](#), the surviving spouse shall not have the benefit of any homestead allowance.

B. Family Allowance- at death, a decedent may be entitled to a priority claim against the estate's assets for a "family allowance."

i) **District of Columbia-** a family allowance of \$15,000 is payable out of the personal estate of the decedent to provide for the personal use of the decedent's surviving spouse or minor children²⁶.

ii) **Maryland-** provides a family allowance of up to \$5,000 for the surviving spouse and \$2,500 per dependent, unmarried child²⁷.

iii) **Virginia-** Dependents of the decedent in Virginia for example are entitled to a total of \$18,000 or monthly payments of up to \$1,500 for up to a year in order to provide "reasonable support" for surviving dependents²⁸.

C. Exempt Property in Probate Estates

i) **District of Columbia-** Beneficiaries are entitled to exempt an amount not exceeding \$10,000 in excess of any security interests therein, in any personal property of the estate, including "household furniture, automobiles, furnishings, appliances, and personal effects."²⁹

ii) **Maryland-** Maryland does not provide any statutory exemptions.

²⁵ Va. Code Ann. § 64.1-151.3

²⁶ D.C. Code Ann. §19.101.04

²⁷ Md. Code Estates and Trusts §3-201

²⁸ Va. Code Ann. § [64.1-151.1](#)

²⁹ D.C. Code Ann. § 19.101.03

iii) **Virginia-** The surviving spouse or surviving minor children are entitled to a value not to exceed \$15,000 in excess of any security interests therein in household furniture, automobiles, furnishings, appliances and personal effects³⁰.

D. Bankruptcy

Neither a deceased person nor his/her estate is eligible to file for bankruptcy, 11 U.S.C. §109. However, the Personal Representative, heirs and interested persons may file bankruptcy in order to obtain the benefit of the automatic stay from creditors. This is usually done to stop a foreclosure. The alleged interest in the estate property is treated under 11 U.S.C. §541 as property of a bankruptcy estate to be protected until a future ruling by the court.³¹

E. Maintenance- is related to the family allowance, probate codes often provide surviving dependents or spouses with access to estate assets before creditors in reasonable amounts necessary to provide for their maintenance.

F. Augmented estates (VA & MD)- in Virginia and Maryland, a surviving spouse may decline the designated gift under the will and elect to take a statutory share of the estate assets instead. The decedent's "augmented" estate is calculated by combining the estate subject to probate with other assets passing outside the probated estate.

G. International Estate Administration- Note that administration of an international decedent's estate can involve additional pitfalls and unfamiliar statutory schemes. Traditional notions of what constitutes a valid will or asset protection device may not apply.

H. Forced Shares- statutorily created mandates that require certain beneficiaries or heirs must be included in the distribution of a decedent's estate. Although more common in foreign jurisdictions, this is not a concept

³⁰ Va. Code Ann. § 64.1-151.2

³¹ For a discussion of Bankruptcy and Probate: <http://pearlstein-law.com/bankruptcy&probate->

completely alien to US estate administration which often requires forced shares for spouses.

I. Prioritization of Claims- When estate assets are limited or insufficient to pay all claims in full, each state has a statute that prioritizes claims by class. These priorities can be found as follows.

i) District of Columbia: §20-901 et seq

ii) Maryland: E&T Article, §8-105-108

iii) Virginia: §64.1-157,158

See <http://pearlstein-law.com/InsolventCLE9-27-2007.pdf> for a list of the priorities regarding the treatment of insolvent estates and pages 17 to 24 as to the statutory priorities..

5. Wills and Estates

Traditional estate planning provides the backbone of any asset protection plan.

A. Testamentary Trusts- a trust which arises upon the death of the testator, usually under his or her will. Testamentary trusts are distinguished from *inter vivos* trusts, which are created during the settlor's lifetime.

Since testamentary trusts are not owned by the beneficiaries, they cannot be reached by creditors and will offer some degree of protection to indebted beneficiaries. However, any income distribution to a beneficiary will not be protected from a creditor once it has been made.

B. Spendthrift Clauses³²- Spendthrift provisions in trusts prevent beneficiaries from transferring or assigning their rights to future income or principal payments. They also prevent the beneficiaries' creditors from attaching a beneficiary's interest to satisfy creditors' claims³³. Lawyers have traditionally used spendthrift trusts when settlors believed their beneficiaries were unstable or undisciplined profligates.

³² <http://www.pearlstein-law.com/asset.html>

³³ Rosenberg v. Rosenberg, 64 Md. App. 487, 517, 497 A.2d 485, 500 (Md. App. 1985).

i) **The District of Columbia** recognizes spendthrift provisions.³⁴ Attorneys need not use any special language as long as the trust instrument evidences the settlor's intent to create a trust that prohibits assignment by the beneficiary and attachment by creditors. Under District law, discretionary trusts and support trusts also protect assets from the claims of the beneficiary's creditors. However, spendthrift trusts will not protect the trust corpus from claims against settlors who are also trust beneficiaries, claims for the support of a beneficiary's minor children, or debts incurred for necessities.

ii) **Maryland** also recognizes spendthrift provisions, protecting both trust income and principal from beneficiaries' creditors' claims.³⁵ Under Maryland law, discretionary trusts and support trusts also protect assets from the claims of the beneficiary's creditors. However, Maryland spendthrift trusts will not protect the trust corpus against claims (1) upon settlors if they are also trust beneficiaries; (2) for alimony and child support; (3) of a beneficiary's creditors if the beneficiary has the power to withdraw trust assets upon demand; or (4) of the Internal Revenue Service for income taxes.

iii) **Virginia** case law and by statute recognizes spendthrift provisions at, Virginia Code Title 55-545.02 &.03.³⁶ This \$500,000 limit applies to all beneficiaries taken together. Under Virginia law, discretionary and support trusts also protect assets from the claims of the beneficiary's creditors. However, Virginia spendthrift trusts do not protect the trust corpus against the following: claims of the United States, Virginia, or any county, city, or town; state claims for reimbursement for public assistance, including medical assistance, furnished to the beneficiary, other than beneficiaries with disabilities; and claims against settlors who are also beneficiaries, subject to certain limitations. Virginia law also invalidates Virginia trusts that grantors create for their own benefit that purport to suspend or terminate the beneficiaries' interest if they apply for medical assistance or require medical, hospital, nursing, or custodial care.

³⁴ *United Mine Workers of America v. Boyle*, 567 F.2d 112 (D.C. App. 1977)

³⁵ *Cherbonnier v. Busseg*, 92 Md. 413, 48 A 923 (1901).

³⁶ *Bennett v. Bennett*, 2008 U.S. Dist. LEXIS 46959 (D.C. 2008)

iv) **Bankruptcy**- The bankruptcy courts will apply the state law. If a valid spendthrift clause has been created, the trust will not become the property of the bankruptcy estate.³⁷

6. Trusts

There are a myriad of trusts for different purposes. Trusts can be broken down into revocable and irrevocable trusts that are one of three forms: simple, complex or grantor trusts. Both revocable and irrevocable trusts may be created during life (*inter vivos*) but all testamentary trusts are irrevocable.

A. Revocable Trusts- a trust created *inter vivos* by a grantor who retains the power to revoke the trust and re-acquire its assets. Property held in this type of trust remains the property of the grantor, is accessible by creditors, and thus does not provide asset protection. See Section 2 C. iv) above regarding asset protection afforded tenancy by the entirety property transferred into a revocable trust.

B. Irrevocable Trusts- a trust usually designed to remove assets from the grantor's estate to minimize the estate tax or any testamentary trust. Once created, an irrevocable trust cannot normally be amended by the grantor and is under the control of the trustee. (However, some modern trust statutes and case law allow amendments by the court or by full agreement of all concerned parties.) Unlike revocable trusts, property in an irrevocable trust is no longer owned by the grantor, and is therefore not subject to attack from his creditors absent a fraudulent conveyance or the extent of powers and benefits retained by the grantor. There are a large variety of irrevocable trusts, some of which are described below.

i) **Grantor Trusts**- is a hybrid irrevocable statutory trust for which someone other than the trust (normally the grantor) bears some or all of the income tax liability. This may also be known as a **Defective Grantor Trusts** (DGT). I.R.C. Sections 673–677 and 679, and the related regulations, determine whether a trust may be treated as a grantor trust. A properly structured grantor trust allows the trust assets to grow for future generations.

³⁷ Bieger v. Heep, 1999 U.S. App LEXIS 19125 (4th Cir. 1999)

The income of the trust is borne by the grantor while the assets of the trust will not be included in the grantors taxable estate.³⁸

Common methods to bring it under the statute include: (1) retaining the right to reacquire trust assets; (2) allowing the grantor to benefit from trust income; (3) creating the trust to allow a reversionary interest greater than 5% of the trust assets at the time of creation; (4) allowing the grantor to control of the distribution of trust income; (5) giving the grantor a Crummey power; and/or (6) giving the grantor or non-adverse trustee the power to pay life insurance premiums of the grantor or their spouse.

The grantor trust is irrevocable and will be protected from the grantor's creditors though some liability could result because of the powers granted by the "defects."

ii) **Irrevocable Life Insurance Trusts (ILITs)**- a trust established to own a life insurance policy. By removing the ownership of the insurance from the insured to the trust, the insurance proceeds are not included in the estate of the insured. As an irrevocable trust, ILITs are protected from creditors of the insured grantor.

iii) **Foreign Asset Protection Trusts**- Offshore asset protection trusts have attracted a great deal of attention even though they are appropriate only for the wealthy patron. Offshore trusts are trusts that a grantor may establish in foreign jurisdictions that have enacted laws that protect trust assets to a greater extent than does United States law. The key to establishing an effective offshore trust is choosing a jurisdiction with one or more of the following trust-friendly characteristics:

- The foreign jurisdiction does not recognize foreign (United States) judgments, thereby forcing creditors to litigate their claims in the foreign jurisdiction;

The foreign jurisdiction generally requires plaintiffs to use attorneys who are licensed in that jurisdiction, thus increasing the plaintiff's costs and thereby discouraging the prosecution of their cases;

The foreign jurisdiction generally prohibits contingency fee arrangements, forcing plaintiffs to finance the litigation themselves; and

- The foreign jurisdiction's substantive law is generally much more favorable to the defendant/client.

³⁸ Larson, Howard; *Defective Grantor Trusts can be Boon in Asset Protection and Estate Planning*, 41 Orange County Lawyer 18 (April 1999).

A few countries that currently satisfy the criteria are Bermuda, the Cayman Islands, the Cook Islands, the Isle of Man, and the Bahamas.

iv) **Domestic Asset Protection Trust (DAPT)**- also known as “Alaska”, “Nevada” or “Delaware” trust, is available in only some states to protect assets from creditors in the same manner as an offshore trust. DAPTs are currently subject to a 10-year avoidance reach back period for bankruptcy matters, and can be created only in states where they are specifically provided for by statute. Three common aspects of DAPTs are (1) allowance of a self-settled spendthrift trust, (2) shortened statutes of limitations for creditors to challenge the transfer of assets, and (3) more conservative fraudulent conveyance definitions, increasing the burden on the party seeking to demonstrate the invalidity of the conveyance.

v) **Dynasty Trusts**- are irrevocable trusts designed to avoid estate taxes and pass wealth to posterity. The Dynasty or Generation Skipping trust is an important tool for those wishing to pass wealth through multiple generations. Two important limitations of the Dynasty trust are the common law rule against perpetuities and the Federal generation-skipping transfer tax. The Rule against perpetuities, where not made optional by statute (as it has been in DC), limits the ability of grantors to make dispositions that outlive a life in being plus 21 years. As irrevocable trusts, the grantor is provided protection from his/her creditors.

vi) **Foreign Grantor Trusts**- a trust is considered foreign if (1) it is not primarily supervised by a US Court, and (2) there is not at least one US citizen with the authority to control the assets of the trust. Foreign Grantor Trusts are created under IRC §671-79 as Grantor Trusts, but do not qualify as domestic grantor trusts because they lack the above two criteria.

As asset protection devices, these trusts have the benefit of NOT being subject to US courts and may therefore be able to offer additional protection from creditors not otherwise found in US jurisdictions.

vii) **Special Needs Trusts**- a trust designed to provide for the care of a disabled loved one without jeopardizing their eligibility to receive various government benefits. This trust serves the dual purpose of providing for a disabled beneficiary while never placing substantial assets directly under their control.

47 U.S.C. 1396(d)(4)(A) allows protection of the trust assets that are used for a person with special needs that is eligible and using Medicaid and other public funds for his/her care and support. However, the statute requires that the assets of the trust are subject to Medicaid and other public liens at the death of the beneficiary. These trusts are typically used to protect a damage award from a personal injury or malpractice case.

Case law in Virginia and the District allow government claims against trust assets³⁹.

When the source of the support will be from private funds, a discretionary special needs trust may be created. With a spendthrift provision and the discretion to terminate the trust given to the trustee, the assets will be protected from creditors of the beneficiary.

viii) **Disclaimer Trusts-** a trust funded by a surviving spouse or heir after death to disclaim specific assets, thereby moving those specific assets into a trust for the benefit of other heirs. Disclaimed property interests are transferred to the trust, without being taxed as a gift but are included in the estate for estate tax purposes.

A serious challenge may arise if estate assets are disclaimed for the purpose of avoiding the creditor(s) of the disclaiming party. Such a challenge by creditors will be reviewed by a court and may be avoided if a fraudulent conveyance or fraud can be proven.

ix) **Bypass Trusts-** a trust designed to keep assets out of the estate of the beneficiary, usually for the benefit of the grantor's spouse. The primary protection offered by this is against the IRS. By placing residual marital assets into a bypass trust with the surviving spouse as a beneficiary, the taxable estate of the surviving spouse may remain small enough to be exempt from federal estate tax. The bypass trust assets can be protected from the creditors of the grantor and the estate unless there are insufficient assets in the estate to pay the claims. A spendthrift clause will protect the beneficiaries.

x) **Charitable Remainder Trusts-** a Charitable Remainder Trust (CRT) provides for annual payments to non-charities with a remainder of the assets passing to a charity at the end of the beneficiary's life. These

³⁹ Commonwealth v. Huynh, 262 Va. 165; 546 S.E.2d 677 (2001) (allowing recovery of state medical expenses); In re: Brown, D.C. Superior Court LEXIS (2007) (allowing the court to access trust funds to pay attorney's fees).

trusts generally entitle the grantor to income tax deductions equal to the actuarial value of the remainder. A CRT must meet the requirements of I.R.C. § 664, various treasury regulations, and revenue rulings. As an irrevocable trust, the assets of the trust are protected from the grantor's creditors,

xi) **QTIP Trusts**- a qualified Terminable Interest Property (QTIP) trust establishes a trust for the benefit of the surviving spouse. This trust allows a 100% marital deduction for the first spouse to die but the assets will be included in the estate of the surviving spouse. After taxes, the remaining assets will go to the designated beneficiaries who are usually the children of the first spouse to die. As an irrevocable trust, there is asset protection for the grantor..

xii) **QDOT**- stands for a Qualified Domestic Trust, and is a trust designed to pass the marital exemptions when the surviving spouse is not a United States citizen. Because the marital deduction applies only to US citizens, non-citizen spouses will not receive the standard marital exemption unless assets are placed in a QDOT and administered by a U.S. Trustee. As irrevocable trusts they offer protection to the grantor and for the beneficiary with a spendthrift clause.

xiii) **GRATs, GRITs & GRUTs**- are estate planning technique that minimizes the estate tax liability existing when intergenerational transfers of estate assets occur. Under these plans, an irrevocable trust is created for a certain term or period of time. The individual establishing the trust (the grantor) pays a gift tax when the trust is funded And may receive annuity payments. When the trust terminates the beneficiaries receive the assets free of income tax and the grantor's estate tax is reduced.

xiv) **Qualified Personal Residence Trust (QPRTs)**- A QPRT is an irrevocable trust designed to hold the term holder's personal residency in trust for a specified number of years, requiring that the term holder continuously use the residence, and then passing the residence on to the beneficiaries after the trust ends

Asset protection under a QPRT is somewhat limited. Since the settlor will also be the term holder, and he grantors are the trust

beneficiaries, creditors can reach their beneficial interest though that interest is less than 100%.

7. Insurance and Annuities

A. Life Insurance

Certain life Insurance benefits may be protected by state statute. However the cash surrender value of a whole life policy is usually not protected from creditors or from a Trustee in bankruptcy unless specifically exempted by statute.

B. Annuities

Apart from certain retirement benefits, annuities are usually created by a contract between a private party and an insurance company or some other financial entity. The beneficiary makes a lump-sum payment or a series of payments, and in return the insurance company agrees to make periodic payments at a future date. Annuities typically offer tax-deferred growth of earnings and may include a death benefit that will pay your beneficiary a guaranteed minimum amount, such as your total purchase payments.

There are generally two types of annuities: fixed and variable.

i) **Fixed annuities**- guarantee a minimum rate of interest during the time that your account is growing, and guarantee that the periodic payments will be a guaranteed amount per dollar in your account. These periodic payments may last for a definite period, such as 20 years, or an indefinite period, such as your lifetime or the lifetime of you and your spouse.

ii) **Variable annuities**- Offer investment opportunities in a variety of investment opportunities. The rate of return on the purchase payments, and the amount of the periodic payments eventually paid, will vary depending on the performance of the investment.

Variable annuities are securities regulated by the SEC. Fixed annuities are not securities and are not regulated by the SEC. Equity-indexed annuities combine features of traditional insurance products (guaranteed minimum return) and traditional securities (return linked to equity markets). Depending on the mix of features, an equity-indexed annuity may or may

not be a security. The typical equity-indexed annuity is not registered with the SEC.

iii) Creditors of Annuitants

Private annuities can offer protection from creditors if there is no fraudulent conveyance unless there is a cash surrender value of the annuity. However there are many state statutes that exempt certain governmental annuities.

i) District of Columbia: D.C Code §15-501

ii) Maryland: Md. Code Ann. Cts. & Jud. Proc. § 11-504(h)

iii) Virginia: Virginia courts will allow garnishment of annuities, even if the annuity does not specify when it will vest⁴⁰. In addition, Virginia courts will allow alimony and spousal support to be paid from annuities⁴¹.

8. Gifting

A. Gifts that are not deemed fraudulent conveyances are an acceptable asset protection technique. However, the gift tax may make this an expensive process. Gifting is usually inadequate for the very wealthy unless it is directed to a charity that provides a tax deductible and tax free transfer.

B. Medicaid Spend Downs- In order to qualify for Medicaid benefits, the total amount of gifts (and transfers of assets) made within the last five years will be considered. Any efforts to spend down to qualify for Medicaid by gifting should be done cautiously and in consultation with a Medicaid expert.

9. Post Mortem Planning

⁴⁰ Bosco v. Bosco, 18 Va. Cir. 284 (1989).

⁴¹ Va. Code Ann. § 20-107.3

A. Disclaimers- When a beneficiary's assets are subject to the claims of creditors, he/she may wish to avoid receiving assets left by will or otherwise. There are few cases in the local jurisdictions on this point but it can be anticipated that a challenge will be incurred by a serious creditor if there is enough money at stake. If fraud or a fraudulent conveyance is proven, the disclaimer could be avoided and the debt paid.

i) District of Columbia: The District has adopted the Uniform Disclaimer of Property Interests Act (UDPIA), codified at D.C. Code Ann § 19-1501 et. seq. The UDPIA, adopted in 2007, allows intended beneficiaries a great deal of flexibility in post-mortem planning.

ii) Maryland: Under the Maryland Uniform Disclaimer Property Interest Act (Subtitle 2 of Title 9 of the Estates and Trusts Article), a person is entitled to disclaim property that would otherwise go to that person by reason of a devise or by reason of titling.

Maryland courts have held that a Medicaid recipient's attempted disclaimer of property to remain eligible for benefits, although proper under Maryland law, was repugnant to public policy and served to make the recipient ineligible for Medicaid⁴².

iii) Virginia: In *Bosco v. Bosco*, 18 Va. Cir 284 (Va. Cir. Ct. 1989) the court held that under Va. Code Ann. § 64.1-191, defendant was entitled to disclaim the insurance proceeds. The court held that the statute did not have a provision providing for creditors to object to the disclaimer⁴³.

B. Bankruptcy: See Section 4, D above.

10. Avoiding a Probate Estate

Many people avoid a probate estate by using transfer at death accounts and/or the designation of beneficiaries on insurance policies and retirement accounts. Because of the lack of flexibility, this is almost never recommended for large estates and often causes problems with small estates.

⁴² *Troy v. Hart*, 116 Md. App. 468, 697 A.2d 113 (Md. App. 1997).

⁴³ *Abbott v. Willey*, 253 Va. 88, 479 S.E.2d 528 (1997).

A. Conveyance by operation of law- if assets can be made to transfer automatically upon death, probate can be avoided. Examples of this method include: payable-on-death bank accounts, retirement accounts, transfer-on-death securities, transfer-on-death vehicle registration (not available in DC, MD, or VA), ownership as tenants by the entirety, ownership as joint tenants with rights of survivorship, and revocable living trusts.⁴⁴

If there is no estate, there is nothing for a creditor to claim. But a creditor may succeed against the beneficiary if it can prove fraud, a constructive trust or prove that a joint survivorship account was intended only to be for convenience and was not intended as a permanent transfer to the joint holder.

11. Divorce

A. Pre and Post Marital Agreement.

The best way to protect the assets of a divorcing couple is to have negotiated and executed a pre or post marital agreement. If there is no agreement there are at least two main factors to consider.

1) Marital Property

In the absence of such an agreement the courts have the power of equitable distribution of the marital property. The parties may define and identify marital property or the court will do so. Even if there is no agreement the parties may agree that certain assets are not marital property.⁴⁵ Normally marital property does not include gifts, bequests, devises inheritances or property owned by one spouse prior to the marriage which has not been commingled.

ii) Dissipation

⁴⁴ Remember that the revocable trust also needs a pour over will that will require probate. It is almost always the case that some assets of a decedent will not have been transferred to his/her revocable trust,

⁴⁵ Harbom v. Harbom, 134 Md. App. 430, 760 A. 2d 272 (2000). & Falise v. Falise, 63 Md, App. 574, 493 A. 2d 385 (1985)

A spouse is generally free and unrestrained to sell or transfer individual or jointly owned property. The question is whether the spouse is intentionally dissipating the marital assets to harm the other spouse. There is no clear definition of dissipation but these factors are important for the court to consider. 1) Did the sale or transfer take place during the time when the marriage was undergoing an irreconcilable breakdown, and 2) was the transfer made for the benefit of the party making the alleged dissipation and not for the benefit of the marriage?⁴⁶

12. Litigation

There are many judicial procedures and remedies available to creditors and claimants disputing over the rights to assets. These may include the following:

A. Fraudulent Transfers- Each jurisdiction has its own statute regarding fraudulent conveyances that will avoid a transfer of assets: Virginia- Va. Code Ann. § 55-80 (2008)⁴⁷; Maryland- Md. COMMERCIAL LAW Code Ann. § 15-207 (2008); DC- D.C. Code § 28-3104 et. seq. Generally, courts will look to the totality of the circumstances in determining whether a fraudulent conveyance has occurred .⁴⁸

B. Constructive or Resulting Trusts- A trust may be created by a court (regardless of the intent of the parties) to benefit a party that has been wrongfully deprived of its rights.

C. Lis Pendens- This is a written notice on the land records that a lawsuit has been filed concerning real estate, involving either the title to the property or a claimed ownership interest in it. The notice is usually filed in the county land records office. Recording a lis pendens against a piece of property alerts a potential purchaser or lender that the property's title is in question, which makes the property less attractive to a buyer or lender. After

⁴⁶ Herron v. Johnson, 714 A. 2d 783 (D.C. App 1998) & Choate v. Choate, 97 Md. App. 347, 629 A. 2d 1304 (1993)

⁴⁷ See also Buchanan v. Buchanan, 266 Va. 207 (2007).

⁴⁸ 37 Am Jur 2d Fraudulent Conveyances and Transfers § 6

the notice is filed, anyone who nevertheless purchases the land or property described in the notice takes subject to the ultimate decision of the lawsuit.⁴⁹

Both the District of Columbia⁵⁰ and Virginia⁵¹ have enacted statutes to govern lis pendens actions; however, Maryland continues to follow the common law without a codifying statute⁵².

D. Quiet Title- An action requesting a declaratory judgment as to the status of title. All lien holders and interested persons must be named and served.

E. Specific Performance- A suit requesting equitable relief requiring a defendant to perform the terms of a contract or agreement.

F. Partition Action- A joint owner (joint tenant or tenant in common) sues to divide the joint interest by liquidation or in kind.

G. Plea in Title- A defendant's challenge to the title and ownership alleged by a plaintiff in a suit.

H. Declaratory Judgment- A suit asking the court to interpret the terms of an agreement or the status of a party.

I. Predatory Loans- A suit to void the terms of a loan made under allegedly illegal or unconscionable terms or fraud.

13. Ethical Concerns, CAVEAT AGAIN!

Counseling in the field of asset protection may expose the attorney to civil actions against them by creditors and /or beneficiaries. Even worse, such advice may involve ethical violations. Proceed with care. Asset protection advice is legal and critical but think carefully, examine your client carefully and do not act with reckless abandon.

⁴⁹ Nolo.com

⁵⁰ D.C. Code Ann. § 42-1207

⁵¹ Va. Code Ann. § 8.01-268(A).

⁵² DeShields v. Broadwater, 338 Md. 422, 432-42, 659 A.2d 300 (1995).

