Price & Farrington's Estate and Tax Planning *Fast*Facts

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Estate, Tax , Business and Wealth Planning for Advisors and Clients

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Asset Protection: *Why Your Assets Might Not Be Safe From Future Creditors*

Asset protection planning is an increasingly important component of overall planning. But is it easy to achieve? And when can a court overturn your –or your client's—asset protection planning? A recent Washington case sheds some not-altogether-comforting light on the subject.

Facts. In 1995 a couple —the Townleys— created the Beaver Valley Trust and transferred their personal residence and some investment property into the trust. At the time they created and funded the trust they had no current creditors. But they admittedly created and funded the trust for the stated purpose of protecting their assets against the claims of *future unknown creditors*. Although the trust had an independent trustee and their children were the beneficiaries, the Townleys were named the "Trust Managers" with the power to handle all trust affairs. The couple continued to live in their personal residence, but didn't pay any rent to the trust or even make utility payments. By 2000, the Townleys had gotten themselves into tax trouble and had been assessed nearly $175,000 in unpaid taxes, interest and penalties. In 2001 they filed for bankruptcy to attempt to avoid the federal tax liability.

Ruling. The IRS filed suit in U.S. District Court to set aside the transfers to the Beaver Valley Trust as fraudulent and to foreclose on the federal tax lien. The Townelys claimed they didn't make the transfers to defraud the IRS since the IRS wasn't even their creditor at the time. They argued that they created and transferred property into the trust to protect their assets from future unknown creditors.

The District Court held that the Townley's admission that they made the transfers to protect against unknown future creditors was a veritable confession of their actual intent to hinder, delay or defraud all potential future creditors, including the IRS. under Washington law (RCW 19.40.041). The court found other factors indicating fraudulent transfers. The Townleys:

- continued to live in their personal residence after the ostensible transfer.
- did not make any rent or utility payments.
- transferred substantially all of their assets to the trusts (so they had no means of paying their tax or other bills as they came due).
- received no consideration when they gifted their property to the trust.

Since the affairs of the trust and the couple were so intertwined as to be indistinguishable, Beaver Valley Trust was really their "alter ego". The property transfer was characterized by "compelling circumstantial evidence" of "multiple badges of fraud" and the trust assets were deemed to be available to satisfy the Townley's tax liability.

The 9th Circuit U.S. Court of Appeals affirmed that the government provided "clear and satisfactory proof" that the Townelys possessed an "actual intent to hinder, delay and defraud a creditor" in violation of the Washington Uniform Fraudulent Transfers Act (UFTA). *See* U.S. v. Townley (9th Cir. No. 04-35767 May 17, 2006)

Planning pointers. This case illustrates at least five very important points for planners and their clients:

(1) The fact that you have no creditors now when you're doing your planning does NOT mean that the planning cannot be challenged as a fraudulent transfer by a later-appearing creditor.

(2) If the stated purpose of your planning is asset protection, i.e., to protect assets against future unknown creditors, that by itself might be enough to establish your actual intent to engage in a fraudulent transfer.

(3) If you're living in a house

Aphorisms on Morality

Devotion to what is right is simple; devotion to what is wrong is complex and admits of infinite variations.
Seneca, 1st century

A man has generally the good or ill qualities which he attributes to mankind. *William Shenstone, 1764*

As I know more of mankind I expect less of them, and am ready now to call a man a good man upon easier terms than I was formerly. *Dr. Johnson, 1783*

Be not too hasty to trust or admire the teachers of virtue; they discourse like angels but they live like men.
Dr. Johnson, 1759

that is owned by a trust of which you are not a beneficiary, and you aren't paying rent to the trust, the arrangement could be set aside as a fraudulent transfer.

(4) If your relationship with the trust is such that there is little or no separation between the financial identities, the trust may be considered to be your alter ego and its assets therefore available to satisfy your creditors.

(5) If you are making transfers to trusts where asset protection is an issue, make "for value" transfers instead of gifts.

No existing creditors does not ensure safety. A myth has persisted in the asset protection world that as long as you do planning when there are no creditors around, it will *ipso facto* be safe. That ignores that the Washington UFTA has an entire section 4 that relates to "*Transfers Fraudulent as to Present and Future Creditors*", and which applies "*whether the creditor's claim arose before or after the transfer was made or the obligation was incurred…*"

This "transferred actual intent" means that *if you do planning with the intent to defeat the rights of any future creditors who may later appear, regardless of who they are, then that intent will be applied to set aside the transfer as to any particular creditor who does in fact appear later*. The UFTA does not, repeat NOT, provide anything like a "safe harbor" simply because the planning was done when no creditors were present IF the planning was done with the intent to defeat any creditors, including future unknown creditors.

Asset Protection's Four-Letter Word: G I F T

The fraudulent transfer laws are primarily aimed at transactions that are without "reasonably equivalent value". The logical reason for this is simple: if the debtor doesn't get back something of value from the transferee, there is nothing available for the creditor to satisfy the judgment. Gifts are inherently without "reasonably equivalent value" since by definition there is no consideration for a gift. Because of this, if asset protection is an issue, gifts should be avoided because they are so easy for creditors to set aside. ■

But what is "asset protection" if not planning that has as its very intention the desire to defeat the rights of creditors, whether appearing now or in the future?

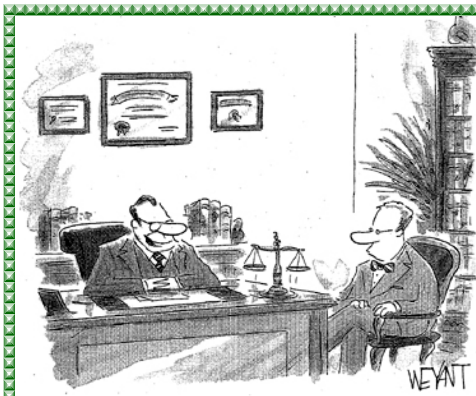
Planning must be done for non-asset protection reasons. Except for homestead protection and other recognized statutory exemption planning (for example, IRAs in Washington) and some business entity planning and spendthrift trust planning, you should not conduct asset protection in its own name. For the Townleys, it had the practical effect of a sworn confession that they had the intent to fraudulently transfer assets as to all creditors who came later. This has significant practical implications:

- You should not sign an engagement letter that says that a purpose of your planning is asset protection.
- Advisors probably should not give clients a memorandum that discusses the asset protective effects of the planning they're about to do.
- You should not give testimony or provide an affidavit that the reason you engaged in your planning was concern about unknown future creditors. That clearly doesn't work.

By and large, the legislatures and the courts want to see creditors get paid on their judgments, and they haven't given unconditional approval to planning that has as its stated purpose the shielding of assets from creditors, even if the creditor who does appear later was totally unforeseen.

If you can't give a straight-faced reason why your planning was done for legitimate purposes (other than to lessen the rights of creditors), that planning could be in grave danger.

Planning with trusts. The Townley case shows that if you place a personal residence in a trust and want it to be respected for creditor-debtor law purposes, a normal landlord-tenant relationship must exist between you and the trust, with rent, utilities, renter's insurance etc. You can't have it both ways: if you expect the trust to be treated as a legally independent entity, you must treat it as such, as an arms-length relationship. Just as you cannot treat a business entity like the family piggy bank and think that it will still be respected for creditor-debtor purposes, ditto for trusts.



"Give a man a fish, he'll eat for a day. Teach a man to sue, and he'll eat for a lifetime."

The Bottom line. Asset protection is a very difficult planning area. This case illustrates that there is no "safe harbor" simply because the planning was done at a peaceful time when there were no creditors on the horizon. This myth is now exploded. You cannot do asset protection planning in its own name and expect it to survive scrutiny. ***The real art of asset protection planning is creating a fundamentally sound plan to accomplish legitimate objectives that, as a collateral consequence, has a solid asset-protective effect.*** ■

As always, we wish you good planning! Let us know how we may help. GDP