"ASSET PROTECTION PLANNING IN TEXAS"

By Gregory W. Sampson
Board Certified in Estate Planning and Probate Law
by the Texas Board of Legal Specialization

I. INTRODUCTION TO ASSET PROTECTION PLANNING:

Estate planning seeks to manage, preserve and distribute wealth efficiently and in a manner consistent with the client's overall planning goals. It is the preservation and protection of one's estate that is the primary goal of asset protection planning in an estate plan. Assessing a client's asset protection needs and choosing appropriate solutions necessitates an overall approach beginning with a review of the client's risk from creditors. Next, he should assess the level of protection his assets already have, his overall estate distribution goals, applicable tax minimization techniques and, of course, his willingness to implement such a plan. Any change in one's level of asset protection often has broader implications that also must be considered and weighed against the risk being averted.

The increase in litigation and rising concern of many clients that they will become a target and have their assets subject to claims, whether frivolous or otherwise, has increased awareness of and the desire for asset protection planning. Increased insurance costs for liability and other protection has also caused clients to seek other methods of reducing their vulnerability to claims and, hopefully, allowing them to lower their costs of insurance or protect against reduced coverage imposed by insurers.

A. Asset Protection Techniques—What They Are and Are Not. The focus of asset protection planning is to maximize one's allocation of assets among exempt or hard to reach assets through a shift in ownership or control or utilizing liability protected entities. Such planning includes increasing ones state law exempt (or bankruptcy exempt) property, making transfers to others as gifts or in trust, or transfers to other asset protected or limited liability entities, and will and trust drafting to protect assets from creditors after death. Proper asset protection planning is always an advance planning exercise, the timing of which can be critical as planning to remove property from the reach of existing creditors (especially when the debtor is insolvent) can be characterized as fraudulent transfers that can be reversed or found invalid.

Asset protection planning is not planning with respect to current claims or to protect assets from an existing lawsuit. It does not involve hiding assets or otherwise concealing or fraudulently conveying assets. Although some asset protection plans might suggest planning with offshore trusts or transferring assets to other jurisdictions where they will be more difficult to reach, such planning must be approached cautiously, using institutions with established reputations and in safe jurisdictions with well settled and time tested laws, so as not to place assets at greater risk by removing them from U. S. jurisdiction. Asset protection plans should also be careful not to invoke the Fraudulent Transfer Act or a fraud on the spouse or other co-

©2004 Gregory W. Sampson, Esq., Passman & Jones,
A Professional Corporation, 2500 Renaissance Tower,
1201 Elm Street, Dallas, TX 75270-2599; Phone (214)
742-2121, Ext. 2471; Fax: (214) 748-7949; E-Mail:
sampsong@passmanjones.com; wwwpassmanjones.com

owner of any assets. The best asset protection planning is always carefully planned, well documented, and utilizes methods that are established and supported by statutes or significant case law.

B. How Asset Protection Fits Into Estate Planning. Estate planning encompasses many kinds of asset planning, such as probate and trust planning, transfer tax planning, education funding planning, retirement planning, disability planning, elder planning and insurance planning. It is important that the asset protection plan coordinate with these other planning goals and in many cases, multiple goals can be achieved through a single planning method. For example, retirement plans and annuities are generally exempt from claims of creditors, and as such, are wise places for one to invest the maximum that can be invested under applicable tax laws. These assets also have significant income tax deferral benefits. Because of their income tax deferral, however, such assets may be subject to both ordinary income tax and estate tax upon an owner's death that can approach seventy-five percent (75%) of the asset. Family limited partnerships (discussed more fully below) can have significant estate and gift tax reduction advantages, business or property management advantages, as well as asset protection advantages. Family limited partnerships also generally receive significant valuation discounts when properly structured with marketability and control restrictions that can make gifts of partnership interests preferable to undiscounted assets. As with any gift, however, one must consider the transfer of basis from the donor that can lead to significant capital gains taxes upon later liquidation of the partnership since the gifted partnership interest will not receive a step-up in basis on the death of the owner. Whether the income tax disadvantages that might be realized by an estate is outweighed by its asset protection advantage, is something for the asset protection advisor and his client to determine in light of all of the property of the estate, the transfer tax laws that would be applicable, and the implications of other available methods.

C. How to Identify Clients Who Are In Need of Asset Protection.

1. Ask the Client. Often, the person who knows best his or her level of risk of creditors' claims is the client, who should be asked whether a risk of creditor's claims is a concern for him or her and for the future beneficiaries of his or her estate. Many clients are aware of claims being made against people in their industry or profession or may, because of the people with whom they do business or who are in their family, anticipate litigation over business or estate issues. Also, since one important and common method of asset protection is good liability insurance protection, clients should be asked to assess their comfort with the amount of coverage they have and whether it should or can be increased.

2. Clients With Elevated Liability Risks. Although all of us may be sued at some time for an auto accident or other liability-based claim, certain of us have much greater risk of being included in a lawsuit based on our profession, property we own, or activities in which we engage. Below are lists of those who might be at greater risk of potential claims and who would do well to consider asset protection planning in their estate plan.

(a) Medical Professionals. We are all well aware of the risks of lawsuits faced by doctors, nurses, lab technicians and other healthcare professionals. Aside from the traditional medical malpractice lawsuits for mistakes made by medical professionals, there are also more innovative liability claims being made and a perception of extreme jury awards that have led to a big push for tort reform in the medical malpractice arena. Also, because of the recent trend toward specialization, doctors often feel less comfortable with making a diagnosis without including a specialist, and this type of consultation increases the number of doctors who might be sued for any malpractice action.

Although past legislatures in Texas have addressed medical malpractice tort reform, it was again heavily addressed in the current legislative session resulting in House Bill No.4, the Omnibus Civil Justice Reform Bill, which generally takes effect September 1, 2003 (with some provisions effective July 1st). In brief, that bill attempts to limit the non-economic damages that can be awarded for medical malpractice for any one claimant to $250,000 for all healthcare providers and $250,000 for any healthcare institution (or $500,000 for claims against more than one healthcare institution). Wrongful death claims from medical malpractice are limited to $500,000 per claimant. No limits are set for actual or economic damages. In order for the legislature to set these limits, however, the voters must pass a constitutional amendment, the election for which is set for September 13, 2003.

One result expected from this legislation if permitted by constitutional amendment, is to lower insurance rates and encourages doctors to keep their practices in Texas, though this remains to be seen. Notwithstanding the trend toward tort reform, doctors continue to be concerned about their risk for liability even when tangentially associated to a case and because of this and concerns about the availability of good, affordable malpractice coverage, doctors are usually very receptive to asset protection planning.

(b) **Legal Professionals.** Of course, attorneys, paralegals and others practicing in the legal profession are at risk for legal malpractice claims, which have risen significantly in past years. Although well adept at advising their own clients, a surprising number of lawyers have little or no estate planning and often, even less asset protection planning of their own. Lawyers do have an advantage of understanding well the risks of litigation and the advantages of proper asset protection planning. They also have the ability to understand the complexities of some of the asset protection planning methods, and generally are receptive to implementing those ideas. Similar to doctors, occasional sharp increases in legal malpractice costs also make attorneys interested in protecting their own assets. This is particularly true for those with policies that have substantial limitations on coverage for professionals who are being asked to perform broader services and expand their practice areas for their clients in a difficult economy. There are also some particularly risky legal specialties that have increased risks for claims that increase the cost of coverage, such as securities work, divorce and family law, tax advice and acting in fiduciary capacities. Many corporate attorneys and in-house counsel are concerned about the impact of their new responsibilities under the Sarbanes-Oxley Act.

(c) **Accountants**. The accounting profession has also seen a recent increase in claims and is even more keenly aware of liability in light of the Enron and World Com cases and their involvement in providing financial and tax advice to companies and individuals with aggressive tax accounting or with whom a conflict of interest may develop.

Many accountants providing audit and tax advice are concerned about the impact of the Sarbanes-Oxley Act on their practices. Like lawyers, most accountants have an understanding of the need for asset protection planning and an ability to understand the importance and the complexity of some asset protection methods.

(d) **Construction Industry**. Generally, those involved in construction can be at risk for claims when construction projects fail or business ventures related to those construction projects fail. Those at risk include the contractors and sub-contractors who perform work that are found to be sub-standard. Architects and engineers involved in the planning and overseeing of construction can have similar liability. Real property appraisers can also be subject to liability for appraisals that are misleading or fail to address important factors that result in failed ventures or lending. All of these professions have experienced occasional increases in their liability insurance costs.

(e) **Restaurateurs and Other Alcoholic Beverage Providers**. Liability for drunken driving accidents and other injuries related to over-consumption of alcohol, have extended beyond the drunk driver to employers who fail to address drinking problems, and restaurateurs who allow one to drink to excess and leave the premises in that state.

(f) **Brokers and Financial Advisors**. Certainly any financial advisor or stockbroker with discretionary trading authority is at high risk because of the fiduciary responsibility owed to his principal. More recently such professionals have also been the target of disgruntled investors who feel they have not been properly advised by analysts about the conditions of companies or mutual funds in which they are encouraged to invest. In most cases, the broker or financial advisor as well as his firm or institution is included in the suit and claims of intentional fraud or misrepresentation are often not included in their liability coverage.

(g) **Real Property Professions.** Certainly, owners of real property have always been a target for claims involving any injury on a property and they are ultimately responsible for claims that might exceed liability coverage on the property. Real property owners are also subject to severe penalties for violations of environmental protection laws and can be held responsible even though they are a subsequent purchaser of affected property and had nothing to do with its condition. *See* the Comprehensive Environmental Response, Compensation and Liability Act of 1980, 42 U.S.C. § 9601¸*et seq.* (West Supp. 2003). Property managers are similarly held liable as agents of owners and more creative claims are becoming common, such as claims for injury resulting from intentional criminal acts. Such claims are often based on the property managers or owners failing to inform property visitors of risks of injury from criminal activity. Real estate brokers are frequently under fire for failing to properly disclose property defects and are often included in lawsuits against owners because of representations made.

(h) **Corporate and Other Entity Officers or Directors.** Although corporate officers and directors are often indemnified by their corporations for acts performed on behalf of the entity, and as shareholders may be protected from interior liability of a corporation, recent developments in the Enron and World Com cases and attention on Capitol

Hill to excesses of corporate managers and owners and laws addressing their excesses, have caused a great deal of concern among these business professionals. It remains to be seen whether their officer and director liability insurance coverage or errors and omissions coverage will be sufficient to meet these requirements, and the premiums for such coverage is almost certain to rise.

(**i**) **Trustees.** Many people do not consider their acting as a Trustee on a family or friend's trust or serving as an executor of an estate as a particularly risky position, but it most certainly is. Discretionary authority granted to Trustees puts a large fiduciary burden on such persons and can result in lawsuits many years down the road for decisions made in that fiduciary capacity. Recently enacted laws more carefully identifying fiduciary standards such as the prudent investor rule and rules on allocation of principal and income may result in an easier method of measuring one's breach of a fiduciary duty and might, therefore, result in more prolific litigation. *See* Uniform Prudent Investor Act at Chapter 117 of the TEXAS TRUST CODE; and *see* Uniform Principal and Income Act at chapter 116 of the TEXAS TRUST CODE. Both of these acts provide default rules that may change the way trustees invest or allocate assets, depending on the extent to which the trust agreement addresses these issues. Similarly, those who serve, whether professionally or as volunteers, as trustees of charitable trusts or directors or officers of charitable organizations, are finding less and less charitable immunity protection and are increasingly concerned about their personal liability for actions of the charity.

D. Introducing the Concept to Clients. Attorneys should always ask clients whether they feel they are at risk for claims of creditors and whether or not they would like to take measures to better protect their assets. When gathering information about a client's estate, it is important to ask not only for the value and identity of all property, but also for the debts against such property and any personal liability assumed by that client, whether by guarantee of loans or participation in business ventures where there are guaranties or co-signed loans. Investigation of debts can help reveal whether there is a likelihood a client will default if certain circumstances change such as a downturn in the economy or layoff. A client should also be asked if there are any risks associated with his or her profession and whether they believe there is sufficient insurance to protect against it. This is generally a good point at which to address how asset protection planning could help that client better preserve his or her estate.

When a client seems to be at risk but does not seem to fully understand why asset protection planning is advisable in their circumstance, it might be good to review the following:

1. Runaway Lawsuits. It is not hard to find examples in the newspaper of cases where ridiculous fact circumstances lead to unimaginable judgments with excessive awards, such as the McDonalds' scalding coffee case. A client should also consider that if medical malpractice claims are curtailed by tort reform and workers' compensation claims have already been curtailed, whom do they think the personal injury and other plaintiffs' attorneys will turn for future lawsuits?

2. **Cost of Defense.** Review with the client what typical costs might relate to a simple breach of contract claim or a tort liability claim, even if they should prevail as a defendant. When adding the costs of depositions, trial, and if applicable, experts, not to mention the potential for mediation before trial, such costs can be surprising to many clients who may not have ever been sued in the past. It might also be wise to remind a client that when assessing a case on a contingency, plaintiffs' attorneys assess (i) liability, (ii) potential damages and (iii) the defendant's ability to pay. Among these three criteria for deciding whether or not to pursue a case, only one's ability to pay is within the control of your client. This is where asset protection planning can be a valuable tool.

3. **Review a Client's Non-Exempt Property to Identify The Property That Is At Risk From Claims of Creditors.** Ask a client how much of his or her non-exempt property they could afford to lose. Consider approaching it from another perspective, such as asking how much of their investment portfolio they could afford to lose without damaging their intended estate plan, which is something most invested clients have thought a lot about lately. Then ask them if they would be any happier to lose that property in a lawsuit, which would have the same net effect to their estate.

4. **Review Insurance Protection**. One of the first steps of any asset protection planning is to assess a client's liability and other insurance protection, to determine whether or not it is adequate or needs to be enhanced. If asset protection planning can be accomplished by increasing insurance and doing so is affordable in comparison to other asset protection methods, then the client may well choose to do that in lieu of additional asset protection planning. Otherwise, the asset protection techniques discussed more fully below should be reviewed to determine if any will meet the client's needs and fit well within their overall estate plan.

II. FORMS OF PROPERTY OWNERSHIPS FROM THE ASSET PROTECTION PROSPECTIVE:

A. Joint Ownership.

1. **Tenancy in Common.** Under Texas common law, property may be owned by more than one person as tenants in common who possess undivided but several and distinct interests in the same property, with unity of possession. *See Republic Prod. Co. v. Collins,* 7 S.W.2d 187, 187(Tex. Civ. App. – Eastland 1928, writ ref'd.). Tenancy in common may be created with either real property or personal property. Generally, each tenant in common owns an undivided fractional share of the property, and the interest of a co-tenant is severable and may be transferred as an undivided interest. This means a creditor of a co-tenant can reach his undivided fractional interest. Once a creditor attains this undivided interest, he may likewise sell or transfer the interest, provided there is a buyer who would be interested in an undivided interest with other co-tenants whom he or she presumably does not know. Generally, each co-tenant is entitled to the same right of possession and use of the property, which is not exclusive. If property is in use by a co-tenant, its profits, such as rents, received by a co-tenant requires that he account proportionately to the other co-tenants for those profits. *Haynes v. Ramillion,* 242

S.W. 2d 444, 447 (Tex. Civ. App. – Fort Worth 1951, writ ref'd. n.r.e.) and *Poenisch v. Quarnstrom,* 386 S.W.2d 594, 598 (Tex. Civ. App. – San Antonio 1965, writ ref'd. n.r.e.). Similarly, co-tenants are collectively responsible for care, maintenance, upkeep and preservation of the property and may charge such expenses to each co-tenant in accordance with their pro rata ownership. *Gonzalez v. Gonzalez,* 552 S.W.2d 175, 181 (Tex. Civ. App. – Corpus Christi 1977, writ ref'd. n.r.e.) and *Minus v. Doyle*, 141 Tex. 67, 170 S.W.2d 220, 222-223 (1943). Expenses entitled to contribution include taxes, repairs, maintenance and insurance premiums, and may also include accrued interest on such expenses and allow a lien to enforce repayment. *Schluter v. Cell,* 194 S.W.2d 125, 133 (Tex. Civ. App. – Austin 1946, no writ). Consequently, depending upon the particular property, tenant in common ownership can make a property less attractive to a creditor, especially if it is not marketable, has expenses or taxes to be allocated among co-tenants, and is not easily divided for partition purposes.

(a) **Right of Partition.** Texas statutes do provide a right of partition to each co-owner, which can be accomplished by agreement among the parties, or otherwise by judicial decree. The procedure for a judicial partition of real or personal property may be found in the Texas Property Code § 23.01 *et. seq.* and Texas Rules of Civil Procedure § 760 (West 2002) *et seq.* Such an action does not divest an owner of title, rather it simply vests each co-tenant with a separate ownership of the share allotted to them, thus it is not a conveyance or transfer of title. *Hailey v. Hailey,* 160 Tex. 372, 331 S.W.2d 299, 303 (1960) and *Zapatero v. Canales,* 730 S.W.2d 111, 115-116 (Tex. App. – San Antonio 1987, writ ref'd. n.r.e.). Once partitioned, the owner of his allotted share of the partitioned property has exclusive use and occupancy rights and the right to dispose of that share as he sees fit. *Hamilton v. Hamilton,* 154 Tex. 511, 280 S.W.2d 588, 593 (1955). In order to file an action for partition, a party must then be an owner with possessory rights. In order to attain a judicial partition order, the court must determine that the property is divisible in kind, and if not, the court may order that the property be sold and the profits be divided proportionately among the co-tenants. Each co-tenant may pursue reimbursement of expenditures and payment of his or her pro rata share of any profits or rent in the judicial order, if proven. TEX. R. CIV. P. § 760 (West 2002).

If a partition would be required for a creditor to obtain any value out of co-tenancy property, this may provide a significant barrier or at least make the property less attractive and allow a negotiation for a discount on the debt owed. Since one cannot always know whether property would be marketable or whether other parties would be willing to agree to a partition, it is not wise to rely very heavily on the unattractive nature of tenancy in common as an asset protection method. If all the co-owners are friends or family and would agree to form a limited partnership, that may provide for better protection as will be discussed more fully later in this outline.

2. **Joint Tenancy.** Joint tenancy in Texas is very similar to tenancy in common, being defined as two or more persons who possess equal and undivided interests in the same property with unity of possession. Joint tenancies may be with or without rights of survivorship, but rights of survivorship will only apply if they are expressly agreed to in writing by the parties. *See LeBus v. LeBus,* 269 S.W.2d 506, 510 (Tex. Civ. App. – Fort Worth 1954, writ ref'd. n.r.e.). *See* TEX. PROB. CODE *§* 46 (West 2002).

(a) Joint Tenancy *Without* Survivorship. If there is no such agreement, any joint tenancy property descends to the heirs and devisees of a deceased co-tenant. *Stegall v. Oadra*, 868 S.W.2d 290, 292 (Tex. 1993). Joint tenancies without right of survivorship are subject to the same basic rights as tenants in common share, as more fully described above.

(b) Joint Tenancy *With* Rights of Survivorship. Rules governing joint tenancies with rights of survivorship as applied to multiple party accounts can be found in Texas Probate Code § 46 (West 2002). Particular provisions pertaining to joint accounts with rights of survivorship, including multiple party accounts, can be found at Texas Probate Code §§ 439 and 439A (West 2002). Community property survivorship agreement provisions are provided in § 451 through 462 of the Texas Probate Code.

Joint tenancies with rights of survivorship are little different from tenants in common while the debtor/co-tenant is living, but this significantly changes upon the death of a joint tenant. At that time, the survivorship agreement vests all the property immediately in the survivor. Thus, if a creditor is not able to obtain an interest in the property before the death of a joint tenant/debtor, then they may be left with only a conditional or secondary right to collect such property. Texas Probate Code § 442 (West 2002), provides that "no multiple party account will be effective against an estate of a deceased party to transfer to a survivor sums needed to pay debts, taxes and expenses of administration, including statutory allowances to the surviving spouse and minor children, if assets of the estate are insufficient." Thus, a creditor must be able to show that there are no other assets of the estate that can satisfy its debt before it can proceed against multiple party accounts passing by survivorship, and the priority of estate administration expenses, taxes and family allowance might further diminish a creditor's claim to such account. A similar provision applies to joint accounts with survivorship in community property which requires the surviving spouse to account to the estate for any joint or sole management community property of the deceased spouse received by survivorship necessary to pay the decedent's debts. TEX. PROB. CODE § 461. Both statutes place a two (2) year statute of limitations on suits to collect from survivorship property and is counted from the date of death.

It should be noted, that in Texas, persons added to title of a property or an account as a joint tenant with right of survivorship, are only deemed to own the portion of that account for which they have made their own contribution. Texas Probate Code § 438 provides that "a joint account belongs, during the lifetime of all parties, to the parties in proportion to the net contributions of each to the sums on deposit, unless there is clear and convincing evidence of a different intent." Consequently, naming a survivor on an account for which no contribution was made by the survivor, does not create a gift of half of the account to that survivor at the time their name is placed on the account and, consequently, does not work to avoid creditors of the contributing joint tenant.

(c) Implications on Estate Planning. When deciding to create a joint tenancy with right of survivorship interest in property, several estate planning implications must be considered. First, any property passing automatically to a survivor is a non-testamentary disposition that is not subject to the provisions of one's will. Thus, if estate planning trust provisions are provided in the will, a joint tenancy with right of survivorship asset will not be available to fund that trust, which could create underfunding of a credit shelter trust in some circumstances. Second, joint tenancy property not held as community property, will not be entitled to a step-up in basis to the extent it was contributed by or owned by the surviving joint tenant. Third, joint tenancy accounts can create an imbalance in the dispositive scheme of one's estate, if expenditures from or growth in various accounts differ and different beneficiaries are named on those accounts. This may result in a different allocation among those beneficiaries than might have existed at the time the survivor's name was added to an account or property.

3. Tenancy by the Entirety. Another form of joint ownership in a common law jurisdiction is a tenancy by the entirety. This is defined as an equal and undivided interest in property with right of survivorship, held by a husband and a wife as one person. Under common law, a creditor of one spouse cannot reach this property, because neither spouse can convey title alone. Some states only allow real estate to be held in a tenancy by the entirety form, and some government claims are not subject to this limitation. Because Texas is a community property state and this common-law rule would completely undermine the community property nature of ownership, Texas and other community property jurisdictions have not recognized it.

B. Community Property Liability. Texas is a community property state, meaning that property earned during the marriage is considered to be community property subject to equal division upon termination of the marriage (whether by divorce or death), making it essentially equivalent to property equally owned one-half (½) by each spouse. In common law states, generally, the name of the titleholder of the property is deemed to be the owner. In common law states, one spouse might be able to insulate his or her assets from the other spouse by holding it in his or her sole name. In Texas, on the other hand, community property can be exposed to the debts and creditors of both spouses. In order to better understand the risks of community property being subject to each respective spouse's creditors, we must first analyze the various classifications of community and separate property in Texas.

1. Marital Property Classifications. A definition of "*separate property*" and "*community property*" and various classifications of community property, have been codified and carefully described in Texas Family Code § 3.001 to 3.006. Property over which a spouse has the power of sole management, control and disposition is defined in §§ 3.101 through 3.104 of the Texas Family Code. A description of marital property liability and its allocation among the various classifications of marital property, is described in §§ 3.201 through 3.203 of the Texas Family Code.

a) Separate Property—Defined by Statute. Under § 3.001, a spouse's separate property consists of:

(i) Property owned or claimed by the spouse before the marriage;

(ii) Property acquired by the spouse during the marriage by gift, devise or descent; and

(iii) The recovery for personal injuries sustained by the spouse during marriage, except any recover for loss of earnings capacity during marriage.

b) **Community Property—Non-Separate Property.** Section 3.002 defines *"community property"* as the property, other than separate property, acquired by either spouse during the marriage. There is a presumption of community property in § 3.003, which may be overcome by providing clear and convincing evidence that a property is actually separate property of the spouse. A spouse can clarify his or her separate property by recording a schedule of it in the deed records of the county in which the parties reside or where the subject real property is located. Such a filing will be notice to a creditor as to real property, if it is acknowledged and recorded in the deed records of the county in which the real property is located. TEX. FAM. CODE, § 3.004 (West 2002).

Texas follows the inception of title rule for determining the ownership of property that has been partly purchased with separate property and partly purchased with community property. TEX. FAM. CODE. § 3.006 (West 2002). Essentially, this means that the initial source of funds and the manner in which property was originally purchased (as evidenced in a sales contract or lien documents), will determine whether the property is separate property of one spouse or community property of both spouses. When one owns separate property by the inception of title rule, but makes significant contributions with community property, then there may be a right of reimbursement. *See Cameron v. Cameron,* 641 S.W.2d 210 (Tex. 1982) and *Eggemeyer v. Eggemeyer,* 554 S.W.2d 137 (Tex. 1977). Under legislation effective in 2001, there is a codified right of economic contribution provided in Texas Family Code §§ 3.401 to 3.410 to account for benefits to one's separate or community property from the other. Gifts of community or separate property to a spouse should be separate property of the recipient's spouse and is presumed to include all of the income and property that may arise from that property under § 3.005 of the Texas Family Code.

2. **Allocation of Marital Property Liability.** There are essentially four questions to be asked to determine whether a spouse's separate property or share of community property is subject to the debts of the other spouse. Those questions are: (i) Is it the husband's debt, the wife's debt, or both? (ii) Was the debt incurred prior to or during the marriage? (iii) Is it tortuous or non-tortuous debt? (iv) Are there any other rules of law that would make one spouse personally liable for the other spouse's debt? Once these questions have been settled, then the Texas Family Code § 3.202 would generally make the determination.

(a) **Five Categories of Marital Property.** There are essentially five categories of marital property:

(i) Husband's separate property;

(ii) Husband's sole management community property;

(iii) Joint management community property;

(iv) Wife's sole management community property; and

(v) Wife's separate property.

Sole management community property is the property over which a spouse has the sole management, control and disposition that the spouse would have with respect to that property if single. Any other property is considered jointly managed community property unless the spouse provides differently by power of attorney in writing or other agreement. TEX. FAM. CODE § 3.102 (West 2002). Texas Family Code 3.002 provides further that sole management community property includes (i) personal earnings, (ii) revenue from separate property, (iii) recoveries for personal injuries, and (iv) increase, mutations of, and revenue from such sole management property. Commingling sole management community with joint management community, however, makes it joint management community property. Assuming a spouse is able to avoid commingling, one can determine whether the non-debtor spouse's property will be subject to the other spouse's debt. Obviously, each spouse will have his or her own separate property and all of his or her community property share subject to his/her own debts. Beyond that, liability generally attaches to that property which the debtor spouse has the power to manage under § 3.202 of the Texas Family Code. Thus, the following rules of thumb generally apply:

1. A spouse's separate property is not subject to any liabilities of the other spouse. TEX. FAM. CODE § 3.202(a).

2. A spouse's sole management community property is not subject to any non-tortuous liabilities of the other spouse incurred during the marriage. TEX. FAM. CODE § 3.202(b). A spouse's sole management community property is also not subject to any liabilities incurred by the other spouse prior to the marriage. *Id.*.

3. All community property (joint and sole management) is subject to the tortuous liability of either spouse incurred during the marriage. TEX. FAM. CODE § 3.202(d).

Despite this clear codification of rules determining liability, the courts have confused the issue some with cases looking at the totality of the circumstances to determine whether the community is responsible for the debts of a spouse. The Texas Supreme Court determined in *Cockerham v. Cockerham,* 527 S.W.2d 162 (Tex. 1975), that "…debts contracted during marriage are presumed to be on the credit of the community and are thus joint community obligations, unless it is shown that the creditor agreed to look solely to the separate estate of the contracting party for satisfaction. The critical issue for a non-contracting spouse to be liable for such debt is whether the non-contracting spouse had knowledge of the transaction, assented to it and whether the non-contracting spouse contributed toward any payments. Presumably, the later dated Texas Family Code provisions outlined above supercede the *Cockerham* analysis, which is somewhat supported by language indicating acceptance of the codified determination of liability in the Texas Family Code. *See Carr v. Houston Business Forms, Inc.,* 794 S.W.2d 849 (Tex. App. – Houston [14th Dist.] 1990, no writ).

(b) Allocation of Spousal Liability Under the Probate Code. Although the provisions of the Texas Family Code § 3.202 (West 2002) carefully delineate community property between sole management community and joint management community, this distinction does not appear in the Texas Probate Code thus, some have suggested that at death a decedent's one-half (½) interest in the other spouse's sole management community property may be subject to non-tortuous debt incurred during the marriage by the decedent. *See* Thomas M. Featherston, Jr., *"A Trust and Estates Perspective of the Texas Marital Property Law"*, in State Bar of Texas, ADVANCED ESTATE PLANNING AND PROBATE COURSE, 11 (2002). Nevertheless, at death, the surviving spouse has a few new weapons in its arsenal that may be helpful in protecting community property assets from the decedent's creditors. The surviving spouse is entitled to retain the homestead (even if it is separate property of the decedent) and continue possession thereof without partition by any other owner until the surviving spouse's death or abandonment. *See* TEX. PROP. CODE §§ 283-285 (West 2002). A surviving spouse is also entitled to a list of certain exempt property other than the homestead or may take an allowance in lieu of such exempt property TEX. PROB. CODE §§ 280 and 281 (West 2002). Exempt property referred to in those sections is the same as the Texas Probate Code's list of exemptions at § 142.001, *et seq.* A surviving spouse or any minor children of a decedent is also entitled to a family allowance, equal to one year's living expenses, provided the surviving spouse does not have separate property adequate to the survivor's maintenance. TEX. PROB. CODE § 286-293 (West 2002).

(c) Exceptions Creating Liability for Debts of the Other Spouse. Exceptions to the codified rules of thumb under the Texas Family Code that would cause a spouse's community or separate property to be liable for the other spouse's debts include the following:

(i) Joint Obligations. If both spouses sign a contract or are jointly liable for a tort, they would be jointly and severally liable and subject all of their marital property to that liability.

(ii) Vicarious Liability. There are situations where a person can be held personally liable for acts of another, including (i) *respondeat superior; (ii)* acting as an agent, (iii) partnerships; (iv) joint ventures and other special relationships. *See Lawrence v. Hardy*, 583 S.W.2d 795 (Tex. Civ. App. – San Antonio 1979, writ ref'd n.r.e.). The Texas Family Code § 3.201, however, is clear that the marriage relationship does not constitute these special relationships by itself and does not create a vicarious liability relationship.

(iii) Necessaries. Since each spouse is obligated to support the other spouse and any minor children, debts incurred for such "necessaries" can be made payable out of any marital property. *See* TEX. FAM. CODE § 2.501 (West 2002) and *see also* § 154.001.

(iv) Taxes. Even if spouses file separate returns, it appears that to collect a tax deficiency, the IRS can attach all of the deficient spouse's sole management community property as well as one-half (½) of the sole management community property of the other spouse. *See Medaris v. United States*, 884 F.2d 832 (5th Cir. 1989).

(v) Federal Preemptive Liens. Various federal liens may be superior to other liens on the same property, allowing them to override state property exemption statutes. Two cases out of the U. S. Supreme Court outline some of these priority liens. *See United States v. Kimbell Foods*, 440 U. S. 715, 740 (1979).

3. Planning With Community Property. There are several things spouses can do to maximize their protection of separate property and sole management community property from the other spouse's debts. First, a spouse can certainly try to avoid jointly signing any contractual obligation or loan documentation so that only one spouse is personally liable for that debt. Preferably, the spouse with fewer assets as their separate property or sole management community would be the preferred debtor. Then, the spouses should take care to properly maintain the different classifications of their marital property, and, if appropriate and not disadvantageous to their overall estate plan, consider converting joint management community property into sole management or separate property.

(a) Record Keeping. Spouses need not go to great lengths to protect their separate property or sole management community property from debts of the other spouse if they are able to keep careful records and clearly identify their property as such. For example, each checking account can be clarified in its title as a separate property account of the husband or a sole management community account of the wife. One of the greatest oversights in maintaining separate property, is failing to separate the income on separate property (which is community property) from that separate property. All income on separate property accounts should be immediately transferred to a community property account to avoid commingling. Each spouse should also take care to pay their own debts out of their own sole management community or separate property as appropriate. Spouses should also avoid contributing their sole management community or separate property toward expenses of the other spouse's property, or otherwise commingle them. Businesses that are separate property or sole management community property should also have careful business records kept indicating that those assets are clearly kept separate from personal assets of the spouses. General ledgers showing transactions separately with respect to each account and how it is related only to the debts of the separate property owner or sole management community spouse are also helpful.

(b) Trusts. In order to assist in keeping property separate, the spouses could create separate property trusts and sole management community property trusts over which only one spouse would have the control as trustee and arrangements should be made to minimize any commingling or shared management responsibility with respect to those trusts. Similar record keeping is advised for trusts as are recommended for separate accounts for businesses as above.

(c) Gifts. Spouses may make gifts of community property to each other that thereafter constitute separate property. Spouses may make unlimited amounts of gifts to each other without incurring gift tax. Some spouses create trusts for each other that can provide income to the donee spouse for their lifetime, but the principal is distributed in accordance with the terms of the trust. Unlike an outright gift, the donor does not lose control over the ultimate beneficiary of the trust. Such trusts can also allow the trustee to make distributions of principal subject to some discretionary standard. Such trusts are similar to QTIP trusts under a will and can work well to protect assets from creditors of the donor spouse but care must be taken not to make the trust subject to the donee spouse's creditors by avoiding characterization of the donee spouse as a transferor (or self-settlor). Thus, it may be necessary for the donor spouse to use only his or her separate property to fund the trust rather than community property that would be, in part, attributable to the donee spouse. The transferor spouse should also not serve as trustee or have any rights of reversion or any other opportunity to become a beneficiary, otherwise it will be subject to the self-settled trust rules. Whenever making gifts to spouses, however, one must remember that as separate property of the spouse, it will not be subject to the step-up in basis on the death of the transferor as is enjoyed by the surviving spouse's one half (1/2) of community property.

(d) **Partition or Marital Property Agreements**. Texas Family Code § 5.52 permits spouses to partition their property, which usually converts community property to separate property. When making partitions, one must be careful not to create a fraudulent conveyance, if it is done with the intent to hinder creditors or affects existing obligations. Similarly, marital property agreements can be made either prior to or subsequent to a marriage for the purpose of identifying and protecting separate ownership of property. TEX. FAM. CODE § 5.43 (West 2002). In particular, marital property agreements can partition assets among separate and community property and can address the character of income and provide that income from separate property remain separate property. TEX. FAM. CODE § 5.53 (West 2002). Maintaining separate property income as separate property greatly reduces the risk of commingling, but also has long-term implications for the spouse that is giving up that community property right. Although such agreements can address liabilities and attempt to avoid joint liability of the community for the debts of a spouse, such agreements are void with respect to rights of a pre-existing creditor whom the spouse is intending to defraud by entering into the agreement. TEX. FAM. CODE § 5.56(a) (West 2002). Actual or constructive fraud claims are also a concern with respect to reallocation of liability for existing debts. Similarly, an agreement requiring one spouse to discharge an obligation incurred by the other or incurred jointly, does not affect the creditor's right to enforce it against either of the obligated spouses. *See Blake v. AMOCO Fed. Credit Union*, 900 S.W.2d 108, 111 (Tex. App. – Houston [14th Dist.] 1995, no writ); *See also* Rush *v. Montgomery Ward*, 757 S.W.2d 521, 523 (Tex. App. – Houston [14th Dist.] 1988, writ denied.).

(e) **Fraud on the Spouse**. Any shifting of assets among separate or community property or in trust or otherwise to avoid creditors of a spouse might also, inadvertently, create a claim by the other spouse under constructive trust theories, commonly referred to as fraud on the spouse. This type of claim is discussed more fully below.

(f) **Ethical Considerations and Conflicts of Interest.** Separately addressed in this seminar will be various ethical considerations. Consequently, I have not punctuated each instance in the planning process at which the attorney should be careful to consider his responsibilities under the Texas Disciplinary Rules of Professional Conduct. It should be stated, however, that any time an attorney is advising a married couple on asset protection that would involve the re-characterization of separate or community property, the restriction of a spouse's rights to that property, or other transfers of that property, a potential for conflict of interest exists that should be addressed at the outset of the attorney-client relationship. In some cases, each spouse should have his or her own attorney, and full disclosure should be made of all of the risks that exist and rights being forfeited to each party.

C. **Exemption Planning.** Certain properties are exempt from claims of creditors by statute. In the context of state law judgments against a debtor, Texas Property Code and other codes provide various exemptions for certain property. In the federal bankruptcy context, the Federal Bankruptcy Code also provides its own exempt property provisions. Bankrupt debtors, under U.S.C.A. § 522(b) may also elect state law exemptions. Because the Texas state exemption statutes are much more favorable than the federal bankruptcy exemptions, in most cases, debtors will elect the state law exemptions in Texas.

1. **Federal Bankruptcy Exemptions.** Federal bankruptcy law exempts the following:

(**a**) Up to $15,000 worth of real or personal property used by the individual or a dependent as a residence or burial plot;

(b) An automobile of up to $2,400.00 in value;

(c) Up to $8,000 in aggregate value of household furnishings (no item to exceed $400.00 in value);

(d) Up to $1,000 worth of jewelry;

(e) Property of up to $800 (plus up to $7,500 of any unused amount of the residence exemption);

(f) Up to $1,500 of the individual's tools of trade;

(g) Any unmatured life insurance contract (other than a credit life insurance contract, plus certain other interests in life insurance);

(h) Prescribed health aids;

(i) The right to receive social security, unemployment, local public assistance, veterans' benefits, disability benefits, alimony and support, certain pension plan payments; and

(j) Certain other miscellaneous rights to property derived from tort claims. 11 U.S.C. § 522(d) (West Supp. 2003).

2. **Texas Exemptions.** The following exemptions apply in Texas:

(a) Homestead Exemption. Texas has one of the most favorable homestead exemptions in the nation, which protects two (2) types of homesteads based on acreage and usage and without regard to value. A homestead exemption is based in the Texas Constitution but is described for creditor purposes in Texas Probate Code § 41.001, *et seq.*

(i) Urban Homestead. The urban homestead exemption protects up to 10 acres of land (including improvements) if a family or a single adult person uses the land as a homestead. TEX. PROB. CODE § 41.002(a) (West 2002). The homestead is considered urban if, at the time the homestead designation is made, the property is within the limits of a municipality or its extra territorial jurisdiction or a platted subdivision and served by police protection and fire protection and the municipality provides at least three utilities (such as water, electric, natural gas, sewer and storm sewer).

(ii) Rural Homestead. A rural homestead exemption protects up to 200 acres of land (including improvements) for a family using the land as a homestead, but protects only 100 acres of land (including improvements) if a single adult person uses the land as a homestead. TEX. PROP. CODE § 41.002(b) (West 2002).

The owner or co-owner of a property is the one protected by the homestead exemption. When an owner dies, the homestead protection continues for his surviving spouse, a minor child, or an adult unmarried child living in the home. At least five (5) types of liabilities are not subject to the homestead exemption. TEX. PROP. CODE § 41.001(b) provides the following list:

(i) Purchase money debt;

(ii) Ad valorem taxes;

(iii) Certain residential construction liens;

(iv) Refinance liens; and

(v) Certain home equity mortgages.

Certain federal statutory liens are also not subject to the homestead exemption. *See Shambaugh v. Scofield*, 132 F.2d 345 (5th Cir. 1942). A homestead claimant's proceeds from the sale of a homestead are also not subject to seizure for creditors' claims for up to six (6) months after the date of sale. TEX. PROP. CODE § 41.001(c) (West 2002).

When making transfers of a homestead to a trust (for example a qualified personal residence trust *"QPRT"*), in connection with other estate planning or in transferring it to a partnership, one must be careful to consider its overall impact. For example, transferring a homestead to a qualified personal residence trust will necessitate re-designating the homestead for ad valorem tax purposes. Otherwise, the homestead exemption will be lost. Also, transfers to a qualified personal residence trust or partnership might remove ownership from an individual who may claim a homestead exemption against creditors. You must remember that property gifted in trust may lose the right to a step-up in basis that would otherwise have occurred if the property were not contributed to a trust as separate property.

(b) **Personal Property Exemptions.** Texas personal property exemptions are based upon a value of up to $60,000 worth of eligible property for a family or $30,000 for a single adult person. TEX. PROP. CODE § 42.001 (West 2002). Eligible personal property includes the following properties, among which a person can choose those to which he desires to apply his protection. If a person fails to make a selection, the court will do so. TEX. PROP. CODE § 42.003(b) (West 2002). The following personal property (up to the applicable valuation limit) is exempt:

(i) Home furnishings, including family heirlooms;

(ii) Provisions for consumption;

(iii) Farming or ranching vehicles or implements;

(iv) Tools, equipment, books and apparatus, including boats and motor vehicles used in that trade or profession;

(v) Wearing apparel;

(vi) Jewelry not to exceed $15,000 for a family or $7,500.00 for an individual;

(vii) Two (2) firearms;

(viii) Athletic and sporting equipment, including bicycles;

(ix) A two-wheel, three-wheel or four-wheeled motor vehicle for each member of a family or single adult who holds a drivers license (or depends on another to drive them);

(x) Certain animals and forage on hand for their consumption, including two (2) horses and related tack equipment, twelve (12) head of cattle, sixty (60) head of other livestock, one hundred and twenty (120) fowl, and household pets.

In addition, certain exempt personal property not subject to the aggregate value limitations include:

(i) Current wages (except as to court-ordered child support);

(ii) Professionally prescribed health aids;

(iii) Alimony, support or separate maintenance;

(iv) Unpaid commissions for personal services up to $15,000 for a family or $7,500 for an individual, which is included in the aggregate. TEX. PROP. CODE § 42.001(b) and (d) (West 2002).

(c) **Life Insurance and Annuities.** Life insurance and annuities are allowed an exemption separately under the Bankruptcy Code as follows: (i) Any unmatured life insurance contract owned by the debtor, other than a credit life insurance contract; and (ii) A debtor's interest in any policy with a loan value up to $4,000.

The Texas exemption is, again, much broader and relates to certain contracts of insurance and annuities and protects both the owner and the beneficiaries. The Texas Insurance Code provides all money or benefits of any kind, including policy proceeds and cash values, to be paid or rendered to the insured or any beneficiary under any policy of insurance or annuity contract issued by a life, health or accident insurance company, including mutual and fraternal insurance, or under any plan or program of annuities and benefits used by any employer or individual, shall (i) inure exclusively to the benefit of the person designated in the contract, (ii) be fully exempt from execution or attachment, (iii) be fully exempt from seizure to pay any liability of the insured for any beneficiary (whether before or after such benefits are paid), and (iv) be fully exempt from all demands in any bankruptcy proceeding of the insured or beneficiary. TEX. INS. CODE, ANN., Art. 21.22 (Vernon Supp.2003).

Section 6 of that Article also clarifies that certain annuity contracts issued by life, health or accident insurance companies are to be considered a policy or contract of insurance. This clearly covers commercial annuities purchased as investments by an individual, and is not limited only to those provided as a part of an employer's benefit plan for employees. Consequently, it is now clear that the full cash value of an insurance policy and any annuity is exempt in addition to the aggregate personal property exemption (otherwise limited to $60,000 or $30,000).

Again, care should be taken to avoid a fraud on creditors, particularly with respect to payment of premiums. *See* TEX. INS. CODE ANN., Art. 21.22 § 3(1) (Vernon Supp. 2003). If a premium payment would create a fraudulent conveyance, one might consider converting the policy to paid-up status, which might reduce the death benefit but would make it a fully paid up policy that did not require further premiums.

Since the Texas exemption from the policy owner's creditors extends to proceeds paid to a beneficiary, it is important for any beneficiary subject to claims and creditors to separately maintain those proceeds to avoid commingling with non-exempt assets of the creditor. This can be easily accomplished by the insured through creating an irrevocable trust for the benefit of the beneficiary with spendthrift provisions. Otherwise, the beneficiary (particularly if it is the debtor's spouse) might consider placing the proceeds in a trust immediately before any commingling to similarly avoid that result.

Since insurance proceeds made payable to an estate as beneficiary would then be subject to the estate's creditors, it is preferable not to have the estate be the beneficiary of the policy. Naming the estate as a beneficiary also clearly results in the proceeds being taxable in the insured's estate, regardless of who owns the policy. I.R.C. § 2042(1) (West 2002). Similarly, proceeds payable to a beneficiary other than the estate that are subject to a binding obligation to pay debts, taxes or other charges enforceable against the estate are subject to estate tax. *See* Treas. Reg. § 20-2042-1(b) (as amended 1979). When considering gifts of insurance policies, it should be remembered that although an outright transfer would generally qualify for the annual gift tax exclusion, a transfer in trust will not qualify without special present interest provisions as it constitutes a future interest. *See* Treas. Reg. § 25.2503(c) (as amended 1979). You must also be careful not to incur an income tax that would otherwise not be payable on income tax-free life insurance proceeds, by selling the policy for consideration. If a policy is sold, income tax can be avoided only if the transferee is the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, or if the transferee's basis is determined by reference to the basis in the hands of the transferor (like a gift). I.R.C. § 101(a)(2) (West 2002). Because placing an insurance policy in an irrevocable insurance trust has significant other estate tax minimizing advantages and allows the implementation of spendthrift provisions, establishment of such a trust by the insured can be beneficial both to the estate of the insured and his beneficiaries for creditor protection purposes.

d) **Retirement Plans and IRAs.** Texas law provides a broad exemption for retirement plan benefits. Texas Property Code § 42.0021 provides an unlimited exemption for qualified retirement plan benefits and tax deductible contributions to individual retirement accounts (*"IRA")* and individual retirement annuities, including simplified employee pension plans. This exemption applies whether or not a participant's account is vested, but only applies to deductible contributions to IRAs. In the Federal Bankruptcy Code exemptions, the Supreme Court case of *Patterson v. Shumate*, 112 S. Ct. 2242 (1992), made it clear that ERISA was other federal law that protected qualified retirement benefit plans operating under ERISA. This case did not apply to IRA's, consequently, the Texas Property Code was amended to clarify that IRA's are protected under the state exemptions. Any debtor seeking bankruptcy with IRA's, or any other retirement benefit covered by the Texas Property Code that is not an ERISA plan should elect the state law exemptions. Texas Property Code § 42.0021(c) also clarifies that for sixty (60) days from the date of a distribution of a retirement plan or IRA, such distribution shall be free from seizure for creditors' claims if the amounts qualify as a non-taxable rollover contribution. Non-taxable rollover contributions are also specifically protected § 42.002(b) of the Texas Property Code.

Because of the broad protection afforded to retirement plans, any asset protection plan should consider maximizing retirement benefit planning. Recent more favorable amendments to the tax code have increased the amount that individuals can contribute to their 401k, SEPP and other plans, particularly if the plan allows for accelerated catch-up contributions for participants over age fifty (50). Take note that significantly increasing contributions to such plans, when they can be controlled by the client, may give rise to a fraudulent conveyance claim by existing creditors. The down side of such contributions is the restrictions on withdrawals from such plans and the taxes that will apply when later withdrawn.

In addition, deferred income in annuities, IRA's and retirement plans are subject to income tax upon death in addition to the estate taxes. Consequently, all available exempt property should be considered in light of its after-death tax implications to determine the best allocation of funds among exempt assets.

One should also note that retirement plans and IRA's that are disqualified for failing to meet tax requirements may be subject to creditors, since only tax qualified plans are exempt. Clients should consider whether there have been violations that would cause their retirement benefits to be disqualified and therefore, potentially available to creditors claims.

(e) **Section 529 Plans and Prepaid Tuition Plans.** New legislation effective September 1, 2003, adds § 42.022 of the Property Code. This new provision specifically exempts from creditors any contributions to prepaid tuition plans and Section 529 plans, whether or not sponsored by Texas.

3. **Converting Non-Exempt Property to Exempt Property**. When converting non-exempt property to exempt property, the client should consider not only the impact of that change in assets on his or her estate plan and any taxes that might apply, but should also consider whether it would be considered a fraudulent transfer or fraud on the spouse.

(a) **Fraudulent Transfers.** Texas has adopted a version of the Uniform Fraudulent Transfer Act. TEX. BUS & COM. CODE § 24.001-24.013 (West 2002). The Bankruptcy Code also prohibits fraudulent transfers in § 544(b). Such laws allow the reversal of any transfer that would constitute a fraud on existing creditors and the determination of whether such a fraudulent transfer has taken place is dependent on certain circumstances. Key circumstances that would generally occur in asset protection planning, are transfers to or for the benefit of family members, transfers that remove property from the reach of creditors with an intent to do so, and transfers that make a solvent debtor insolvent. Nevertheless, the law does not prohibit one from transferring assets to protect against claims of future creditors. In fact, there is no obligation of a potential debtor to leave all of his assets available for any potential future creditor. Obviously, the best timing for any asset protection planning that involves transfers of assets out of the reach of future creditors, is when there are no expected or threatened claims.

(b) **Fraud on the Spouse.** Sole management community property, being subject to the sole management and control of one spouse, can be transferred without the joinder, consent or even the knowledge of the other spouse. *Massey v. Massey*, 807 S.W.2d 391 (Tex. App. – Houston [1st Dist.] 1991, writ denied.). Nevertheless, the Supreme Court case of *Arnold v. Arnold*, 273 S.W.2d 799 (Tex. 1925), established that a spouse managing community property owes a duty as trustee and is accountable to the community. Thus, a spouse's management of sole management community property is limited by the fiduciary duty owed to the other spouse. *See Carnes v. Meador,* 533 S.W.2d 365 (Tex. Civ. App. – Dallas 1975, writ ref'd n.r.e.). This means the surviving spouse has a duty not to dispose, transfer or diminish that spouse's sole management community property in fraud of the other spouse's right to that property.

It is the burden of the affected spouse to raise the issue of fraud on a community when the marriage terminates (whether by death or divorce). That spouse must show either an actual or constructive fraud, such as a gift to a third party of assets that would otherwise be payable to the spouse when no other provision is made for the spouse in lieu of that asset. This claim sometimes arises with respect to community property life insurance that is left to someone other than the surviving spouse. Generally, a defrauded spouse's remedy is the award of monetary damages to the injured spouse to recoup the value of the share of the community lost through the wrongful act. *See Mazique v. Mazique,* 742 S.W.2d 805 (Tex. App. – Houston [1st Dist.] 1987 no writ). Fraud on the community, however, is not a separate tort cause of action, rather, it is an equitable division action and consequently punitive damages are not appropriate. *See Schleuter v. Schleuter*¸ 975 S.W.2d 584 (Tex. 1998); *Harper v. Harper*, 8 S.W.3d 783 (Tex. App. – Fort Worth 1999, pet. denied.); *See also Barnett v. Barnett,* 67 S.W.3d 107 (Tex. 2001).

In some cases, the courts have used equitable powers to impose a constructive trust on the community assets given to third parties to bring them back. When marriage terminates by death, the managing spouse may be liable to the estate of the other spouse, or vice versa, in the amount of actual damages suffered by the other spouse arising from the fraud on the community. When the estate or the managing spouse (whichever is liable to the other) does not have sufficient assets to satisfy the claim for damages, the court may impose a constructive trust on the third party donee to retrieve the one-half (½) of the community asset that was wrongfully transferred. *Carnes v. Meador,* 533 S.W.2d at 371; *see also Osuna v. Quintana*, 993 S.W.2d 201, 209 (Tex. App. – Corpus Christi 1999, no writ). Whenever exemption planning results in assets being moved to sole management of one spouse or may be subject to ultimate disposition away from the other spouse, one must consider whether it will give rise to a claim of fraud on the spouse upon termination of the marriage (whether by divorce or by death).

III. ASSET PROTECTION PLANNING TOOLS AND STRATEGIES.

After assessing one's need for asset protection planning, maximizing insurance coverage, utilizing forms of property ownership protection and optimizing exemption planning, to the extent additional protective measures must be taken, one should consider making transfers of property exposed to creditors into entities or trusts that may afford additional protection. When making such protective transfers, one must always consider the possibility that a transfer will be recalled as a fraudulent conveyance, which depends largely upon the circumstances surrounding the transfer and, in particular, the debtor's status with existing creditors. When a creditor obtains a judgment and seeks to enforce it, the successfulness of a protective transfer will depend upon the rights that are retained by the transferor or debtor. That is, the creditor with an enforceable judgment will generally stand in the shoes of the debtor and be entitled to whatever interest that debtor would have in any transferred property. Thus, as a general rule, the greater rights, interests or control that are retained by the transferor, the less the protection that is afforded by the transfer.

When deciding to transfer property, after considering the effect of any fraudulent conveyance rules, the estate planner can determine the best manner in which assets are to be held by asking four (4) important questions:

1. Whose creditors are to be avoided (the transferor's, the transferee's [or beneficiary of a trust], or both)?

2. Does the transferor need to retain control over the transferred property or benefits flowing from it?

3. Does the transferor intend to make a gift of all or part of the transferred property?

4. What assets are to be contributed?

As an example, if the transferor seeks to avoid his own creditors, would like to retain control and benefits of the transferred property, and initially does not intend to make a gift of the property, then perhaps transferring the property to a limited partnership or a limited liability company would be preferable to a trust. On the other hand, if the transferor does not need to retain control and can receive only minor, if any, benefits from the property and wishes to make a gift, then an irrevocable trust is probably the better transferee. Because the transferor would have less interest in an irrevocable trust that is properly drafted, his creditors should have less opportunity to reach those assets. On the other hand, because he retains control and an interest in the property, creditors are able to obtain some of the interest he may have in a limited partnership, but an interest that is so much less desirable than the transferred asset itself, that negotiation for a severe discount to settle the debt owned may well result.

A. Trusts. When planning with transfers to a trust, the particular circumstances and the allocation of various responsibilities, rights and benefits can have a huge impact on the successfulness of that transfer. Although the allocation of these responsibilities, benefits and rights can allow one to tailor a trust to almost any particular need, there are essentially two (2) types of trusts widely discussed in estate planning literature. One is a revocable and amendable trust in which the settlor almost always retains an interest as beneficiary (commonly referred to as a living trust). The second is an irrevocable trust in which the grantor may, but often does not, retain an interest, and has significant estate planning advantages, particularly with respect to gift planning. Both types of trusts may be protected by spendthrift provisions, but this protection is severely limited as to any settlor who retains revocation rights or an interest as beneficiary. The discussion below will focus first on the enforceability of spendthrift trust provisions. Next, those rules will be reviewed in the context of the two basic types of trust starting with revocable trusts, then irrevocable trusts. The outline will then address some more common types of trusts and with a focus on their asset protection features, such as insurance trusts, children's trusts and other family transfers in trusts.

1. Spendthrift Trusts. Although trusts can be subject to restrictions that have asset protection advantages, the greatest asset protection advantage afforded to trusts is through the enforcement of spendthrift provisions which prohibit a beneficiary from alienating or transferring in advance any interests held in a trust for that beneficiary in favor of his creditors. Spendthrift trusts are an exception to the public policy against restraints on alienation, and enjoy protection from creditors to some degree in all states. In Texas, the Texas Trust Code, located in Chapters 111-115 of the Texas Property Code, specifically allows for spendthrift trusts in § 112.035. That section provides in part:

> **(a)** A settlor may provide in the terms of the trust that the interest of a beneficiary in the income or in the principal or in both may not be voluntarily or involuntarily alienated before payment or delivery of the interest to the beneficiary by the Trustee.
>
> **(b)** A declaration in a trust instrument that the interest of a beneficiary shall be held subject to a "*spendthrift trust*" is sufficient to restrain voluntary or involuntary alienation of the interests by the beneficiary to the maximum extent permitted by this sub-title.
>
> **(c)** A trust containing the terms authorized under sub-section (a) or (b) of this section may be referred to as a *"spendthrift trust"*.

Thus, in Texas, simply referring to a trust as a spendthrift trust in the instrument, itself, affords the beneficiaries this broad spendthrift protection from creditors. The validity of spendthrift trusts is almost universally and unconditionally accepted in the United States, and has been since the late 19th century. This is reflected in the Restatement (Second) of Trusts § 152(2) (1959) which says "a trust in which by the terms of the trust or by statute a valid restraint on the voluntary and involuntary transfer of the interests of the beneficiary is imposed is a spendthrift trust." Enforcement of this restraint on voluntary and involuntary transfer of the interests for the benefit of a creditor is also reflected in the Bankruptcy Code § 541(c)(2) that states "a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title." This is an exception to the general rule that restrictions or conditions to transfer in an instrument or under state law generally will not protect a debtor's beneficial interest from the reach of the bankruptcy trustee. In this instance, the Texas Trust Code spendthrift trust provision is applicable non-bankruptcy law.

2. Self-Settled Spendthrift Trusts. The importance of a spendthrift trust clause in any trust cannot be understated. Nevertheless, there are exceptions to the broad protection of a spendthrift provision, not the least of which is when a trust is "self-settled" by the beneficiary. Texas Trust Code § 112.035(d) provides, "if the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary alienation of his beneficiary interest does not prevent his creditors from satisfying claims from his interest in the trust estate." This exception is also consistent with the Restatement (Second) of Trust at § 156(2) which goes even further to say "[w]here a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or her for his benefit." Thus, the interest of the self-settlor beneficiary is deemed to be the maximum that could be distributed even in a discretionary trust for his benefit, which appears to be the rule in Texas. *See Bank of Texas v. Republic Nat'l. Bank of Dallas,* 540 S.W.2d 499, 501 (Tex. Civ. App. --Waco 1976, writ ref'd n.r.e.); *see also Matter of Shurley*, 115 F.3d 333, 340 (5th Cir. 1997). This is the case even though there may be no evidence of fraudulent intent on the part of the self-settlor beneficiary. *Id.* at 338 and 340. Thus, a trust beneficiary who self-settled the trust runs a risk that the entire trust, or at least the maximum portion of that trust that could possibly be distributed under any circumstances, will be subject to garnishment by his creditors. *See Bank of Texas* 540 S.W.2d at 502.

Even if a trust does not carry the requisite spendthrift trust provision, it is possible that the spendthrift trust protection can be derived by demonstrating the settlor's intent that the beneficiary's trust interest should not be subject to either voluntary or involuntary alienation. *See* Restatement (Second) of Trust § 152, comment c. Further, some protection may be afforded to non-self-settlor beneficiaries through the use of other trust restrictions. For example, purely discretionary distributions and special powers of appointment (rather than general powers of appointment), and other restrictions prohibiting beneficiary control over trust assets have been found by courts not to make trust assets available to a creditor's beneficiary until actually distributed. These other protective provisions will be discussed more fully below.

(a) **Revocable Trusts.** Generally speaking, one can count on a debtor's self-settled revocable trust being subject to his creditors and includable in his estate for estate tax purposes. *See B*ANKRUPTCY CODE § 541(a)(1) and INTERNAL REVENUE CODE § 2038. According to some jurisdictions merely retaining a power to revoke a trust alone, absent any other interest or evidence of fraud, should not allow creditors to reach the trust. When the power to revoke would vest any interest of the trust in the debtor, however, it should be subject to his creditors. *See* Restatement (Second) of Trusts, § 330, Comment o; *see also* 4 SCOTT ON TRUSTS § 330.12. Some jurisdictions open trusts to creditors when there is a retained power to revoke. This is based on the concept that the retention of revocation is akin to ownership of the trust and in those jurisdictions, the death of the settlor does not defeat his creditors. But where the power to revoke entitles a creditor to compel the settlor to revoke, then the death of the settlor may defeat his creditors. *See* 4 SCOTT ON TRUSTS § 330.12 at 2615-17.

Texas appears to follow the latter interpretation, that is, that a creditor may step into the shoes of the settlor and compel revocation. *See In Re David Porras*, 224 B. R. 367 (W.D. Texas – El Paso 1998), a bankruptcy case in which the bankruptcy trustee seized the debtor's power to revoke and sent a notice to the trustee of the trust doing so and thereby received all of the assets of the trust. Texas Trust Code § 112.033 provides that a disposition in trust is not invalid merely because a settlor reserves or retains (i) a beneficial life interest for himself, or (ii) the power to revoke, modify or terminate the trust in whole or in part, among other retained powers. The Trust Code further provides that the disposition of the trust upon revocation may be provided in the trust instrument. TEXAS TRUST CODE § 112.053. This suggests that a settlor with revocation powers may provide that the assets of the estate upon revocation or termination will not be available to him or his creditors, or payable to any creditors of his estate. In this way, it may be possible to prevent creditors from reaching the trust after his death. Thus, in drafting the debt payment provisions of a revocable trust, one should consider whether allowing payment of the Settlor's debts will actually enhance the creditors potential for collection of debts from the trust. Further, if he has no interest upon revocation of the trust, it is arguable that the Settlor might even prohibit creditors from reaching the trust upon revocation during his lifetime.

From a transfer tax prospective, a settlor who retains an interest as a beneficiary, such that the settlor's creditors can, therefore, reach the trust assets under state law, makes the transfer incomplete for federal estate and gift tax purposes and the entire value of the trust is includable in the settlor's gross estate. *See* Rev. Rul. 77-378, 1977-2CB 347; *see* Treas. Reg. § 25.2511-2(b) (as amended in 1979). As stated above, the power of revocation alone, makes a trust includable in the settlor's taxable estate. I.R.C. § 2038 (West 2002). In summary, the chance that a power of revocation might constitute an interest that causes a trust to be available to the creditors of a settlor coupled with certain inclusion in his estate for transfer tax purposes, makes it wise to avoid settlor revocation powers. If retention of revocation powers is necessary for a settlor and asset protection is a concern, one must be careful to prohibit the beneficiary from having any other kind of interest, including a reversionary interest upon revocation or termination of the trust and careful consideration of then current case law on the matter would be essential.

(b) **Irrevocable Trusts—Grantor Trusts.** The nature of an irrevocable trust makes it a much more viable asset protection planning tool than a revocable trust, if for no other reason than it removes from the grantor's control the power to revoke and, generally, the power to amend. Texas follows the rule that a trust is presumed to be revocable unless it expressly states that it is irrevocable. TEXAS TRUST CODE § 112.051 (West 2002). Even if a trust is irrevocable, any beneficial interests in the trust or control over the trust retained by the settlor can easily cause it to be subject to his creditors, either under the self-settled trust exceptions to the spendthrift trust rule, or by virtue of a creditor's opportunity to step into the shoes of the settlor. Consequently, irrevocable trusts should either expressly provide that the settlor has no interest in the trust or its property and retains no powers over either, or it should be most carefully drawn to limit those retained interests or powers to minimize the access a creditor might have through those powers or interests. Even when a settlor has no interest in a trust he settles, he must be careful not to grant interests or powers to the beneficiaries of that trust that might weaken the spendthrift clause protection.

(i) **Settlor-Beneficiary Interest and Control Issues.** Whenever a settlor (or grantor) retains an interest in a trust, it is generally referred to as a grantor trust. As discussed above, those retained interests may be reached by creditors under the self-settled trust rule, Texas Trust Code § 112.035(d). The trust assets may also be included in the settlor's estate for estate tax purposes. I. R. C. § 2036 (West 2002) (transfers with retained life estate), § 2037 (transfers taking effect at death, including reversionary interests); § 2038 (revocable transfers); § 2041 (powers of appointment); and § 2042 (life insurance policies in which an incident of ownership is retained). In any grantor trust, the extent of the interest or control afforded the settlor is critical to determine to what extent those assets may be reached by his creditors, regardless of who may also be a beneficiary. There are cases in other jurisdictions that indicate the interests of other beneficiaries and limitations on a trustee to make distributions to a settlor (including discretionary distribution trusts) may be sufficient to limit the trust assets that are available to creditors. As stated above, however, Texas seems to follow the rule that the maximum interest that could be available to a settlor will also be available to his creditors.

The Texas case, *Matter of Shurley*, 115 F.3d 333 (5th Cir. 1997), is instructive on the application of the self-settled trust rule and measuring the interests of the settlor that can be reached by a creditor. Here, the Fifth Circuit answered the question as to what extent the assets of a spendthrift trust settled by a bankruptcy debtor and others are included in the debtor's bankruptcy estate. The Fifth Circuit reversed and remanded the case finding that the bankruptcy court mistakenly included all of the trust in the bankruptcy estate, rather than only the portion that was self-settled by the debtor. The subject trust was created in part with contributions by the bankruptcy debtor (being the Marfa Ranch) and in part by her parents and sister. Each sister contributed one-sixth (1/6) of the trust property and the parents contributed the remaining two thirds (${}^{2}/_{3)}$. During the parents' lifetime, the trust distributed income in respect to each settlor's proportionate contribution. After the first parent died, income was distributed equally between the surviving parent and the daughters (the bankruptcy debtor apparently receiving one-fourth [¼] of the total income) and upon the death of the second parent, the debtor split the income from the trust with her sister. It was undisputed that the trust was a spendthrift trust.

The Fifth Circuit criticized the bankruptcy court's presumption that any contribution a beneficiary-settlor makes to the trust causes the entire trust to be available to her creditors. The appellate court also criticized the bankruptcy court's analysis that the debtor exercised sufficient control to make non-contributed assets, subject to her creditors as well.

The court concluded that, under Texas law, only the property that the debtor contributed to the trust is not protected from creditors and should be included as property of the bankruptcy estate, and that all other assets of the trust should not be property of the estate. Thus, the court applied the self-settled trust rule only to the assets that were actually self-settled, which in this case were easily identified as the Marfa ranch since it had not be subsequently sold or any proceeds reinvested. Incidentally, the court commented that had there been reinvestment of assets, a tracing rule would have had to be applied to identify the self-settlor's interests. In reviewing this debtor's interest, the court concluded that the life estate interest in the trust as it related to the Marfa Ranch, coupled with the trustee's discretion to distribute principal to the settlor or her descendants, was a sufficient interest to cause all of the Marfa Ranch (the settlor-beneficiary's contribution to the trust) in the bankruptcy estate. This was due to the court's application of the rule that the maximum amount of a self-settlor beneficiary's interest will be available to her creditors. (citing Restatement (Second) of Trusts § 156(2) (1959)).

As to the rest of the trust, the court refused to find that the same interest factors and some control factors cited by the bankruptcy court were sufficient to include the balance of the trust in the bankrupt's estate (which the settlor-beneficiary did not contribute). The bankruptcy court seemed to say that the level of interest and control held by the debtor was too great to qualify her as a beneficiary protected by the spendthrift clause. The appellate court disagreed and so reversed on that issue and ordered the bankruptcy court to return those non-self-settled assets to the trust. In its analysis, the court reviewed the following factors originally found to constitute too much control by the debtor-beneficiary:

(1) The authority to prevent another settlor from exercising a power to revoke (in this case debtor's father) which lapsed upon his death;

(2) The right to petition three (3) special trustees to terminate part of all of the trust, which is in the sole discretion of the special trustees;

(3) A special power of appointment in favor of her descendants; and

(4) That the liberal distributions by the discretionary trustee and loans authorized under the trust agreement to the beneficiaries constituted *de facto* control by the debtor-beneficiary.

Essentially, the Appellate Court found that the trustee's exercise of discretion would not undermine the spendthrift protection of the trust agreement. The court stressed that spendthrift trusts are not shielded from creditors out of consideration for the beneficiary, but rather they are justified by the right of the donor to control his property and secure its application as he pleases. *See Shurley*, 115 F.3d at 344, (citing *Heinz v. Sands*, 312 S.W.2d 275, 279 (Tex. Civ. App. – Fort Worth 1958 no writ)). Incidentally, this is the crux of the enforceability of spendthrift clauses, that is, that a settlor's right to protect his property in trust from the creditors of a beneficiary is superior to the creditor's claims on a beneficiary for whom other exceptions to the spendthrift trust rule do not apply.

In criticizing the attack on the debtor-beneficiary's special power of appointment, the court noted that Bankruptcy Code § 541(b)(1) excludes from the bankruptcy estate "any power that the debtor may exercise solely for the benefit of an entity other than the debtor". The court also discredited the attack on the somewhat removed powers to revoke or amend or otherwise terminate the trust, because these powers were actually held by other parties and her role could only be as an initiator of the power holder's exercise of discretion to terminate, or as a veto to another's power to revoke.

The clear lesson from the *Shurley* case is that the spendthrift trust clause will be enforced when exceptions to it are not invoked. In that case, however, it would still seem that the income interests of the debtor in the trust, which is not subject to the trustee's discretionary distribution, could be reached by her creditors. But it is only the portion of the trust for which she was the settlor and contributor that would be wholly included in the bankruptcy estate. Incidentally, this would seem to be the same result that would have occurred had the Marfa Ranch been contributed to a separate trust with the same beneficiaries as the larger trust at issue in this case.

(ii) **Domestic Jurisdictions with Self-Settled Trust Protection.** Although Texas clearly does not permit self-settled trusts, whether revocable or irrevocable, to be free from creditors, other jurisdictions have recently enacted laws attempting to allow self-settled trusts to avoid creditors to some degree. Below is a list of those six (6) jurisdictions and a very brief summary of the statutes they have enacted. Although such trusts are appealing because they are located in domestic jurisdictions but seem to have some of the protections that are generally associated with offshore jurisdictions, there are concerns about their effectiveness for out of state residents. In particular, the full faith and credit clause of the U. S. Constitution (U.S. Const. art. IV, § 1) requires each state to recognize the judgments of the courts of the other states. Arguments that full faith and credit does not affect the trust laws of another jurisdiction, because it is the trustee who holds the assets and not the judgment debtor, may not be successful if the judgment creditor pursues an action for fraudulent transfer and joins the transferee trustee in the action to collect. Similarly, the contract clause of the U S. Constitution (U. S. Const. Art. I, § 10) prohibits states from passing laws which infringe on the ability of persons to contract with each other. One would argue under this clause that the extra jurisdictional law infringes upon the ability of a creditor to contract with his debtor by protecting the debtor's assets from claims of a creditor following a contract dispute. Finally, one should note that the supremacy clause of the U. S. Constitution (U.S. Const. art. VI, § 2) allows federal law to take precedence over state trust protection laws, such that a federal bankruptcy court could arguably direct the trustee of an extra-jurisdictional trust to distribute assets to a creditor.

(a) **Alaska.** The Alaska Trust Act enacted in 1997 was the first to attempt to provide "on-shore" trust protection extending common law spendthrift protections to certain qualifying self-settled trusts. Exceptions to creditor protection for self-settled spendthrift trusts include (i) a transfer to the trust was intended, in whole or in part, to hinder, delay, or defraud creditors; (ii) the trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust which would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; (iii) the trust mandates the distribution of all or a part of the trust income or principal to the settlor; or (iv) where the transfer to the trust was made when the settlor was in default thirty (30) or more days in making child support payments. In addition, the Alaska Trust Act provides a stricter statute of limitations with regard to fraudulent conveyances, requiring them to be brought within the later of (1) within four (4) years of the time the transfer was made or (2) one (1) year after the transfer is or reasonably could have been discovered by the creditor. For any claims arising after the transfer in trust, a four (4) year statute of limitations applies. The Act also prohibits certain claims against those assisting creation of the trust as committing or aiding a fraudulent conveyance. The trust must be placed with a qualified Alaska trustee. *See* ALASKA STAT. § 34.40.110 (2001) *et seq.* and ALASKA STAT. § 13.36.310 (2001).

(b) **Delaware.** Also in 1997, Delaware adopted the Qualified Dispositions in Trust Act which can be found at Delaware Code Annotated. DEL. CODE ANN. tit. 12, § 3572-73 (1997). Similar to Alaska, this allows the settlor to retain the beneficial interest in a self-settled trust and have its assets protected from the settlor's creditors at any time prior to the qualified trustee's actually distributing the property or income to the beneficiary. The trust must be irrevocable and the trustee must be a qualified Delaware trustee other than the settlor, but the settlor can appoint "*advisors*". A trust will not be considered revocable simply because the settlor retains (i) the power to veto a distribution, (ii) a testamentary special power of appointment, (iii) receives income from the trust, (iv) receives income or principal from a CRUT or CRAT, (v) receives up to five percent (5%) of the value of the trust pursuant to the trust agreement, or (vi) receives capital distributions in the sole discretion of the qualified trustee or pursuant to an ascertainable standard. DEL. CODE ANN., tit. 12, § 3570 (2001). The Delaware statute of limitations is four (4) years after the transfer is made or, if later, one (1) year after the transfer was or could have reasonably been discovered by the creditor, and four (4) years for any claims arising after the transfer. Exceptions to the protection from creditors of a self-settlor beneficiary include any fraudulent conveyance, and no protection is attained against child support or alimony obligations or personal injury tort liability. DEL. CODE ANN. tit. 12, § 3572(b)(1) (2001).

(c) Nevada. In Nevada a spendthrift trust for the benefit of the settlor must (i) be irrevocable, (ii) not require any part of the income or principal to be distributed to the settlor, and (iii) not be intended to hinder, delay or defraud known creditors. NEV. REV. STAT. § 166.040 (2001). Assets in or out of Nevada may be subject to Nevada's asset protection statute, provided that at least one (1) qualified Nevada trustee has powers including maintaining records, preparing tax returns and the location of administration of the trust is in Nevada. Nevada's statute of limitations are even more advantageous than others. A creditor seeking to reach a Nevada asset protection trust must do so within two (2) years after the transfer is made or six (6) months after the creditor discovers or reasonably should have discovered the transfer, whichever is later. Further, creditors arising after the transfer is made must commence an action within two (2) years. NEV. REV. STAT. § 166.170 (2001).

(d) Rhode Island. In 1999 Rhode Island joined the ranks of self-settled asset protection trust jurisdictions for irrevocable trusts. The trusts must be made subject to Rhode Island laws, be primarily administered there and at least some of the assets held there, and as others, requires that a Rhode Island resident or other qualified corporate trustee be in Rhode Island. The statute requires the trust to provide that the interest of a beneficiary in the trust property or the income from it may not be transferred or assigned, whether voluntarily or involuntarily, before the trustee distributes the property or income to the beneficiary. This protection does not extend to child support or alimony payments or to existing personal injury or property damage tort claims. R.I. GEN. LAWS § 18-9.2-2(9)(iii)(2001). The statute of limitations in Rhode Island is similar that of Alaska and Delaware. *See* R.I. GEN. LAWS § 18-9.2-4(b)(2001).

(e) Missouri. Not necessarily on par with the aggressive statutory protection afforded under the other four (4) states, Missouri has a trust statute that suggests that a self-settled spendthrift trust will be protected from creditors where the settlor (i) is not the sole beneficiary, (ii) does not retain the power to revoke or amend, and (iii) does not retain a right to receive a specific portion of the trust solely identified by the trust agreement. MO. REV. STAT. § 456.080(3) (West 2001). Thus, it appears without further investigation that an irrevocable trust with multiple beneficiaries that provides only discretionary trustee distributions in favor of the settlor, may still have protection from his creditors.

(f) Colorado. It appears that Colorado Revised Statute § 38-10-111 protects self-settled spendthrift trust assets from the future creditors of a settlor only. *See In Re: Balm,* 22 F.3d 1014, 1017 (10th Cir. 1994).

The foregoing summary of the extra jurisdictional laws on self-settled trusts was largely derived from Leonard L. Silverstein, et al., *Asset Protection Planning,* 810 SECOND TAX MANAGEMENT PORTFOLIOS at 91-96 (2002). That treatise should be consulted for more complete analysis of these statutes.

(iii) Offshore Jurisdictions. Placing self-settled trusts in offshore jurisdictions that afford particular asset protection advantages to such trusts, has been widely promoted, but the nature of such jurisdictions and the procedure for assuring protection of domestic assets, can be complicated and a little disconcerting to the average estate planning client. Nevertheless, promoters, many of whom are well-credentialed estate planning attorneys, continue to vouch for their success as asset protection planning tools. A detailed analysis of each jurisdiction is beyond the scope of this outline and presentation, however, I will briefly review the general advantages offshore jurisdictions intend to bring through asset protection trusts and then identify some of the jurisdictions that have been most widely promoted. If offshore protection planning is desired by a client, it is strongly recommended that an expert with significant experience in the field and detailed knowledge of the various jurisdictions and how each might apply to the particular circumstances, is strongly advised.

Generally speaking, offshore jurisdictions are not subject to the full faith and credit clause or the contract clause of the U. S. Constitution. Similarly, because offshore jurisdictions are not governed by the U. S. Constitution, the supremacy clause of the U. S. Constitution would similarly not limit the protections afforded by offshore trusts. Generally, an offshore trust is one under which at least one trustee is not a U. S. resident and where the trust is construed, interpreted, administered, and subject to the laws of a foreign jurisdiction. Favorable offshore jurisdictions generally have some or all of the following favorable laws:

(i) Repealed or replaced the statute of Elizabeth (which otherwise provides unlimited right to sue for fraudulent transfer), and imposes substantial evidence hurdles and short limitations periods creditors will have to contend with.

(ii) Denied comity to foreign judgments, so that any domestic order to release trust funds to a creditor or any fraudulent conveyance judgment is not enforceable. This generally requires that a separate cause of action be re-filed in the offshore jurisdiction holding the trust, whose laws are traditionally hostile to such actions.

(iii) Overrides traditional domestic laws limiting a self-settlor beneficiary from retaining various interests or powers and generally affording all of the protections of a spendthrift trust to a self-settlor beneficiary.

Settlors seeking offshore jurisdictions for their trusts should also consider economic stability of the jurisdiction, political and social stability, compatible language, availability and quality of professional service, and the quality and availability of satisfactory electronic communication, and the extent to which the settlor can proceed against an errant trustee in that jurisdiction. To avail the trust assets of the protection of the offshore jurisdiction laws, the assets to be protected should be located in that jurisdiction. However, some creative methods have been used to avoid transferring assets to that jurisdiction until a creditor threat arises, even though this can generate fraudulent conveyance claims by the creditor. One method is to have a limited partnership or limited liability company where the limited liability shares constituting nearly all of the limited partnership interests or non-managing member interests are held by the trust. The general partner or managing member interest would be owned by the settlor and when a creditor claim arises, the trust could dissolve its shares and move them offshore. Another method is to provide a flight provision in the trust that simply allows the assets to be moved offshore in that event. Yet another method is a sale-leaseback transaction involving the trust so that the debtor only owns a lease interest.

The following is a list of some of the popular offshore trust jurisdictions.

(1) The Bahamas;

(2) Belize;

(3) Cayman Islands;

(4) Cook Islands;

(5) Gibraltar;

(6) Guernsey;

(7) Aisle of Man;

(8) Jersey;

(9) Liechtenstein;

(10) Nevis; and

(11) Turks and Caicos Islands.

3. Non-Grantor Trusts. Irrevocable spendthrift trusts that do not provide any benefits for a Settlor and with respect to which the Settlor does not retain any rights or powers are required to here as non-grantor trusts. Transfers to such trusts are generally considered completed gifts to the beneficiaries and should be entitled to all of the protections of a spendthrift trust clause. Since the trust property would not be considered to belong to the settlor and the trust is not considered self-settled, the Settlor's creditors cannot reach it. Similarly, the creditors of the beneficiary should not be able to reach the beneficiary's interest due to the breadth of spendthrift trust rule. TEX. PROP. CODE § 112.035 (West 2002). Because the flexibility with which irrevocable trusts can be drafted to attain both non-tax and tax objectives, it is important to analyze the effect of various provisions on the asset protection of trusts that are not self-settled.

(a) Spendthrift Trusts Where the Settlor Is Not a Beneficiary. As we saw in the *Shurley* case, with respect to assets not contributed by a beneficiary, the court will give broad spendthrift trust protection even if certain other limited rights and benefits are granted. Again, because the creditor generally can stand in the shoes of his judgment debtor, any benefits payable out of a trust might be pursued by a creditor. It seems clear, however, that distributions of income and/or principal of a trust to be made in the sole discretion of a trustee are not subject to the claims of a creditor until actually paid to the debtor. *Shurley* § 115 F.3d at 344 (citing *Adams v. Williams*, 112 Tex. 469, 248 S.W. 673, 679 (1923), regarding the enforceability of a spendthrift clause, the Fifth Circuit in S*hurley* said "…the purpose of such a trust is not defeated by the fact that the trustee is authorized in his discretion to apply a part of the corpus of the fund to the use of the beneficiary in accordance with the terms of the trust. Neither is the purpose of such trust defeated by the fact that the Trustee is authorized or even required to turn the entire trust fund or property over to the beneficiary absolutely at some fixed time in the future."). Thus, future distributions, whether discretionary or mandatory based on some fixed future date, do not appear to be reachable by creditors of a beneficiary until actually distributed.

(b) Discretionary Distributions Are Protected. The importance of discretion in making distributions to protect a beneficiary's interest from his creditors before distribution, cannot be overemphasized. As stated in Restatement (Second) of Trusts, § 155(1) (1959), "if by the terms of a trust it is provided that the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his uncontrolled discretion shall see fit to pay or apply, a transferee or creditor of the beneficiary cannot compel the trustee to pay any part of the income or principal." The reverence with which this discretionary power is viewed and protected by the courts, is well illustrated in *The Matter of Bass,*171 F. 3d 1016 (5th Cir. 1999), where the court reviewed on appeal the order of a bankruptcy court to a discretionary trustee that the creditor of a non-settlor beneficiary be entitled to three (3) days' prior notice of any distributions to be made under the discretionary distribution provisions of the trust to the debtor-beneficiary. Finding that the trustee would be faced with the dilemma of (i) exercising his discretion to make a distribution after furnishing the seventy-two (72) hour advance notice or (ii) refraining from making the distribution, both of which could lead him to a breach of trust claim, the court concluded the notice would impinge on his otherwise unfettered discretion which is the heart of the spendthrift provision. The court found that imposing the "requirement to furnish advance notice to the trust beneficiary's creditor would eliminate (or at least greatly reduce) the efficacy of the involuntary alienation facet of the spendthrift trust's prohibitions." *Bass* 1171 F.3d at 1030. The court further stated "we are convinced beyond peradventure that, absent fraudulent or egregious acts by the trustee of a wholly discretionary Texas spendthrift trust, federal courts are shackled by the same constraints as are the courts of Texas and they can neither prohibit nor command the exercise of such discretion, or otherwise interfere – directly or indirectly-- with the unfettered discretion of such trustees." The court then concluded that the bankruptcy court had violated firmly established trust law by granting the injunction that indisputably impinges on and interferes with the trustee's non-fraudulent free exercise of discretion. *Id.* at 1031.

(c) Non-Discretionary Distribution Standards Would Not be so Protected. Mandatory current distributions, such as automatic distributions of income and other non-discretionary distribution standards may be subject to claims of a beneficiary's creditors. For example, some courts have held that a beneficiary's creditors can reach spendthrift trusts requiring distributions for the support of a beneficiary who owes support-related debts. An example of such a trust clause would read "trustees shall pay to the beneficiary any amount necessary for his support." This is based on the argument that the creditor stands in the shoes of the beneficiary and can demand of the trustee such mandatory support payments. On the other hand, it is clear from the *Shurley* case that discretionary distributions for beneficiary support would not be attachable by a creditor providing support. Such a clause might read "the trustee may pay to a beneficiary or for his benefit such amounts as the trustee deems advisable, in his discretion." A hybrid type of discretionary support clause might also have protection from creditors because of the discretionary feature. Such a clause might read "a trustee shall pay to or for the benefit of a beneficiary so much of the net income and principal as a trustee deems to be in the best interest to provide for the health, care, support and maintenance of the beneficiary." A similar clause was found protected in the case of *Smith v. Smith*, 517 N.W.2d 394 (1994).

(d) Power of Appointment. It appears to be the prevailing rule that a beneficiary's right to exercise a general power of appointment over trust property, which could be exercisable in favor of himself or his creditors during his lifetime, would be reachable by his creditors, much the same way that the power of revocation in the beneficiary could be exercised by a creditor. This was discussed in *Bank of Texas v. Republic Nat'l. Bank of Dallas*, 540 S.W.2d 499 (Tex. Civ. App. – Waco 1976, writ ref'd. n.r.e.) with respect to a settlor beneficiary, but has been applied in other cases to non-settlor beneficiaries. *See Shurley* § 115 F.3d at 343, where the courts emphasized the fact that the beneficiary held only a special power of appointment that could not be exercised in favor of herself and thus, did not have a level of control causing her not to be treated as a spendthrift beneficiary. *See also Forbes v. Snow*, 140 N.E. 418 (1923); *see In Re: Granwell*, 228 N.E. 2d 779 (1967); *but see Mercantile Trust Co. v. Bergdorf & Goodman Co.*, 173 A. 31 (1934) (finding that a creditor could not reach property subject to a power unless it was exercised by the power holder).

Similarly, it seems clear that a power of withdrawal in favor of a beneficiary would be subject to his creditors. *See* FED. BANKRUPTCY CODE § 541(a); Restatement (Second) of Trusts § 153(2) comment c. Such provisions are common in trusts providing for spouses or children of a settlor. For example, many spouses wish not to be restricted by the ascertainable standard required for them to serve as trustee of a trust for their own benefit under estate tax provisions, so the trust provides that they may withdraw for any reason up to $5,000 or five percent (5%) of the value of the trust (whichever is greater) each year. Such a withdrawal power would probably be subject to the creditors of that spouse. Similarly, withdrawal powers typically provided under insurance trusts pursuant to a Crummey clause, should be available to the creditors of a beneficiary during the stated withdrawal period. The Crummey clause grants a right of withdrawal during the withdrawal period provided in the Crummey notice to that beneficiary when a contribution is made to an insurance trust.

Each of these withdrawal rights are typically limited to the $5,000 or five percent (5%) amount that is not considered a general power of appointment for tax purposes under Internal Revenue Code § 2514(e) or 2041(b)(2). Fortunately, the Texas legislature amended the spendthrift clause of Texas Trust Code § 112.035, by including subsection (e) which provides "a beneficiary of the Trust may not be considered a settlor merely because of a lapse, waiver or release of the beneficiary's right to withdraw part of the trust property, if the value of the property that could have been withdrawn by exercising the right of withdrawal in any calendar year does not exceed at the time of the lapse, waiver, or release the greater of the amounts specified in 2041(b)(2) or 2514(e)…" TEXAS TRUST CODE § 112.035(e) (West 2002). The effect of this provision is to prevent a beneficiary with a right of withdrawal from becoming a settlor of a self-settled trust by virtue of their failing to take such a withdrawal and allowing it to lapse.

(e) **Other Control Factors** As outlined in the *Shurley* case, bankruptcy courts may find that a beneficiary is more than a beneficiary and rises to the level of a settlor if they have certain controls over the trust property. Although the bankruptcy court's application of these control factors was reversed by the Fifth Circuit in that case, control factors analyzed by the bankruptcy court were again analyzed d*e novo* by the appellate court and this may suggest that such factors might be considered in other cases where the facts may be less favorable, perhaps, than was the case for the beneficiary in the case of *Shurley.* Those factors are:

1. The right to revoke the trust in conjunction with another person;

2. The right to terminate or amend the trust;

3. A power of appointment;

4. *De Facto* control over the trustee;

5. Power to remove a trustee (in a sense trustee shopping for more favorable distributions);

6. Borrowing from the trust without express authorizations.

(f) **Beneficiary as Trustee.** When a beneficiary is the sole trustee of a trust and also the sole beneficiary, there may be a merger of equitable and legal title resulting in the beneficiary's creditors being able to reach the property held in trust. *See* TEXAS PROPERTY CODE § 112.034 (West 2002) (discussing terminating the trust if the legal title and all equitable interests in the trust become united in one person). Sub-section (c) of § 112.034, however, provides that "the title to trust property and all equitable interests in the trust property may not become united in the beneficiary, other than the settlor, whose interests are protected under a spendthrift trust…" Thus the spendthrift trust protects a beneficiary from this merger of title although the statute indicates that a new trustee or co-trustee may need to be appointed. In order for there to be a merger of titles, there must be no other interests held by any other beneficiary. A sufficient interest could include even conditional remainder interests, as they are included beneficiaries of a trust. TEX. PROP. CODE § 111.604(2) (West 2002).

4. Special Issues For Insurance Trusts and General Trust Provisions Affecting Creditor Access. Insurance policies have significant tax advantages and have many creative uses for minimizing estate and gift tax in any estate plan. After preparing living trusts or wills that take advantage of credit shelter trust planning and, to the extent advisable, marital trust planning, removing one's life insurance from his taxable estate is often the next estate planning step to be considered. This can be done by making a gift of the life insurance policy to the one who will ultimately receive the death benefits as beneficiary. This is usually a child of the insured, but can be the spouse of the insured in some cases. There is a gift in the transfer of the policy that could be subject to gift tax, if the gift tax value of the policy exceeds the annual exclusion amount (presently $11,000 per donor, per donee). I.R.C § 2503(b) (West 2002). To the extent the gift exceeds the annual gift tax exclusion amount, one could apply some of the applicable credit amount (previously referred to as "*unified credit amount")* and reduce the overall credit shelter amount that would be available on the death of the decedent, rather than paying gift tax. The applicable credit amount is presently $1,000,000 per person but rises to $1,500,000 in 2004. I.R.C. § 2010(c) (West 2002).

(a) Trust Benefits. Although such a gift transfer has the advantage of removing the proceeds of the life insurance policy from the transferor's estate at relatively low costs, the transferee of the policy owns it outright and as such, it is available to the transferee's creditors. In addition, the transferee has full authority to dispose of the proceeds of that policy in his or her own estate, which may not be in the same manner the transferor would prefer. Finally, the transferee or a successor beneficiary under the policy might be a minor or younger than the age at which the transferor would wish them to have uncontrolled access to the death benefits. For these reasons, the transferor often prefers to place the life insurance policy into an irrevocable life insurance trust (*"ILIT"*). Because the ILIT can also be structured as a spendthrift trust, it will usually not be available to the trust beneficiary's creditors.

(b) Funding Issues. When funding an ILIT with an existing policy, the transferor will need to outlive the transfer by at least three years, to avoid the three-year rule of I.R.C. § 2035, which includes any policies in an estate that are transferred by the decedent within three years of his death. To avoid this three-year rule, many insurable policy owners will shop the market for a new policy and, if affordable, create the ILIT first, contribute the premium to the trust and allow the trust to buy the policy, so that the policy is first owned by the trust and the trust is the beneficiary of the policy. Under that arrangement, the three-year rule will not apply, as only the cash gift was transferred from the policy owner and the new policy is first owned by the trust. The trust is necessarily an irrevocable trust, otherwise the gift of cash premiums or an existing policy will not be a completed gift for gift tax purposes. Revocation powers retained by the settlor would cause the policy proceeds to be includable in his estate under I.R.C. § 2038, § 2036, or § 2042.

(c) **Avoid Self-Settlement by Spouse**. When making gifts in trust for the benefit of a spouse, in particular, it is important to avoid allowing the spouse to be a partial settlor of the trust or owning any incidents of ownership. Since the policy or premiums contributed to a trust might be a community property then the spouse may be deemed to have contributed one-half (½) of the initial gift in trust and, therefore, be a partial settlor of the trust. This not only has self-settled trust concerns as outlined above, but also could cause the estate of the surviving spouse to include the insurance policy proceeds upon death. As a settlor of the trust, the surviving spouse's right to benefits under the trust is a retained interest in the transferred property that is includable in his or her estate. I.R.C. § 2036 (West 2003). One way to avoid this result is to arrange for a partition of the gift in trust so that it is entirely separate property of the insured spouse and the spouse benefiting from the policy has no interest in the gift. This will also need to be done with respect to each premium payment that is contributed to the trust.

It is also important not to allow the surviving spouse to have any incidents of ownership in the policy, which can be deemed to occur if the spouse has a general power of appointment over the policy or the proceeds. This can occur when the spouse possesses disbursement powers in favor of the spouse or children. I.R.C. § 2041 (West 2003). Consequently, the surviving spouse should not be the disbursing trustee of an ILIT in which she is also a beneficiary.

(d) **Crummey Withdrawal Rights** When the policy owned by the ILIT requires continuing premium payments, therefore requiring additional annual contributions to the trust, it can be important to qualify those contributions as annual exclusion gifts. In the absence of a withdrawal right given to trust beneficiaries, contributions to a trust owning life insurance that is payable only upon the death of the insured, is actually a future interest gift that does not qualify for the annual gift tax exclusion. Treas. Reg. § 25.2503-3(c) (as amended 1979) (Example 2). In order to convert a future interest gift into a present interest gift, one can provide a "*Crummey*" withdrawal notice clause entitling a beneficiary to withdraw the amount of the contribution for at least thirty (30) days. This present interest withdrawal right will qualify for the annual exclusion, even if the withdrawal is not taken and the withdrawal right lapses.

The Crummey withdrawal power was given its name from the case *Crummey v. Commissioner*, that initiated the acceptance of withdrawal rights as a method to enable use of the annual gift tax exclusion for gifts to an ILIT. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968). The IRS has subsequently accepted the validity of Crummey withdrawal powers to create a present interest, provided it meets certain technical requirements. *See* Rev. Rul. 73-405, 1973-2 CB 321; Rev. Rul. 81-7, 1981-1CB 474; and Rev. Rul. 83-108, 183-2CB 167. As noted in the spendthrift analysis above, any such withdrawal right, may be subject to the beneficiary's creditors during the withdrawal period. After the withdrawal right lapses, however, Texas spendthrift trusts do not consider the beneficiary allowing the withdrawal right to lapse to be a self-settled beneficiary. TEXAS TRUST CODE § 112.035(e) (West 2002).

Further, a spouse of the insured, even if otherwise benefiting from the trust, should not be granted a withdrawal power as that could constitute a general power of appointment and may constitute a retained interest includable in the decedent's estate. I.R.C. § 2041(a)(2) (West 2002). Although there may be ways to limit the spouse's powers and interests as a beneficiary to minimize the estate inclusion affect of these estate tax rules, one should be careful not to risk granting the spouse too much power or too great a benefit and undermine the estate tax exclusion purpose of the ILIT.

(e) **Tax and Debt Payment Provisions**. When drafting the ILIT, as with any other irrevocable trust, one should be careful not to allow the trust's provisions to obligate the trustee to pay any debts or taxes of the estate of the insured. One reason is that such an obligation will make the insurance proceeds includable in the estate of the decedent, as the estate will be a beneficiary of a portion of the policy. *See* I.R.C. § 2042(1) (West 2002). The second reason, is that this would make a trust available to the estate's creditors by enforcing the estate's right to receive those payments for debts or taxes, as appropriate. This runs counter to the wishes of many clients who would like to see the liquid insurance proceeds available to pay estate taxes so that illiquid assets or controlling interest assets would not have to be sold or, even worse, sold at a fire sale, in order to pay taxes that are due within nine (9) months of the decedent's death. Although direct obligation for payment of debts and taxes should be prohibited, the ILIT can and should authorize the trustee to purchase assets of the estate from the executor or loan money to the estate to provide the liquid funds necessary to pay taxes. If expressly authorized in the trust instrument, this should not create a right of any creditor to pursue those assets held by the ILIT.

(f) **Life Insurance Partnerships**. When the limitations of an ILIT are undesirable, some asset protection and estate tax exclusion, to a lesser extent, can be obtained by transferring the life insurance policy to a family limited partnership. Essentially, the partnership owns the life insurance in much the same way that an ILIT would own the insurance, but the insured has an opportunity through retention of a small general partner interest, to retain some control over the policy. Since only the portion of the policy relative to his small general partnership share would be includable in his estate, nearly all of the policy should, theoretically, belong to the remaining limited partners.

Advantages of the partnership ownership arrangement for life insurance are (i) retained control by the insured, (ii) allows amendment of the partnership to adjust to changing circumstances, and (iii) if there is need for the policy to be sold to the partnership, it will avoid the transfer for value rule and retain the income tax-free nature of the proceeds (because the insured is a partner).

Disadvantages of the partnership form of insurance ownership include the possibility that the partnership's incidents of ownership will be imputed to the insured partner and, therefore, includable in his estate. If the policy proceeds are payable only to the partnership, however, his proportionate interest in the partnership should be the only portion of the policy that is includable in his estate. Second, there have been cases questioning the availability of the annual exclusion for premium contributions, which would be dependent upon the right of withdrawal powers that a partner would own in the partnership. Third, family limited partnerships are under scrutiny by the IRS for use in situations that do not reflect a business use and where the business nature of the partnership is not respected. Use of a partnership for ownership of a policy on a partner, would certainly receive this strict scrutiny. Finally, the partnership does not have the complete protection that irrevocable spendthrift trusts enjoy from creditors of the donor of the policy or the beneficiaries of the ILIT.

5. Children's Trusts. Trusts for the benefit of settlor's children are a critical part of any estate plan. Such trusts are important to prevent property transfers to minors that would otherwise necessitate the creation of a guardianship and to otherwise protect young, inexperienced beneficiaries from wasting or misapplying their share of the estate. Of course, any sophisticated child should also readily accept gifts in trust, even for their lifetime, if for no other reason than to take advantage of the spendthrift trust provisions that protect those assets from their creditors. If a child's trust is to last for their lifetime or any time the trust might be distributable to grandchildren because of the death of a child, generation-skipping transfer tax issues arise and must be addressed in the trust instrument.

(a) GSTT Issues. Generation-skipping transfer taxes apply to any termination of a trust paying to skip beneficiaries (more than one generation below the transferor) or trust distributions to skip beneficiaries. I.R.C. §§ 2611-12; 2521-22 (West 2002). Consequently, even though a trust may not be distributed to a grandchild or skip beneficiary until their parent dies, that event might give rise to a generation-skipping tax equal to the highest estate tax rate then applicable (presently 49%). I.R.C. §§ 2602 and 2641 (West 2002). Fortunately, there is a substantial $1,100,000 generation-skipping tax exemption presently available to each transferor and this can be allocated to transfers in trust to reduce the amount that would be taxable. I.R.C. § 2631 (West 2002). Generally, it is advised that this exemption be applied wholly to one trust so that all of the growth in that trust when later paid out to skip beneficiaries will be free from generation-skipping and estate tax. *See* I.R.C. § 2642 (West 2002).

Any amount held in trust over the exemption amount, will often be held in a separate trust subject to a power of appointment in the children of the transferor so that it will be includable in their taxable estates, thus avoiding the generation-skip and the tax. Since a general power of appointment in favor of oneself, their creditors or their estate may enable a creditor of a child to access the trust to the extent of that power, it is important to limit that power to only a testamentary power, that is only exercisable at the debtor child's death. The mere existence of a general power of appointment avoids the generation-skipping tax (and makes it subject to estate tax in the child's estate). Thus the failure to exercise that power of appointment transfers the estate to his descendants or spouse in trust, and still remains asset protected. This is because the executor of the estate does not hold the power, rather the holder was the decedent who died without having exercised it. *See Shurley,* 171 B.R. 769 (W.D. Tex.

1994), wherein the entire trust was not subject to creditor claims of one of the settlors who retained a special power of appointment.

(b) **Trust Extensions**. When a trust is created for the benefit of a child, there is often an age at which the settlor would like the child to have the property outright and free of trust. This is a noble notion but can have drastic results if a child's creditors are beating down the door at the moment in time the trust terminates or is required too make substantial distributions to the child. For this reason, several purchasers have come up with creative ways to try and extend trusts, and therefore, extend the spendthrift protection of the trust. Perhaps the most secure type of provision is one that is wholly dependent upon the trustee's discretion in a wholly discretionary trust. In this situation, a trustee already has only discretionary distribution powers that are not reachable by a spendthrift beneficiary's creditors. The trustee's discretionary decision to continue the trust for that beneficiary as authorized by the trust, should allow that spendthrift protection to continue until such time as he decides, in his discretion, to make distribution. On the other hand, when the beneficiary himself allows the property to remain in trust beyond the time he is otherwise entitled to receive it, it is arguable that he has then self-settled the trust to that extent and invalidates the spendthrift provision as to him. If it is necessary to give the beneficiary the power to continue the trust, one might consider severely limiting the beneficiary's interest in the trust thereafter, so that the maximum benefit that could be attributed to him and, therefore, subject to his creditors, will allow protection for the balance of the trust benefits. For example, consider providing only an income interest upon extending the trust.

An example of an extension clause recently considered by a court involving a Texas debtor, provides some instruction on this issue. In the bankruptcy case *In re: David Porras*¸ 224 B.R. 367 (W.D. Tex. – 1998), the bankruptcy trustee stepped into the shoes of the settlor who retained a power to revoke the trust and then revoked it. The court spends considerable time in analysis of whether or not a particular letter attempting to extend the irrevocable period of the trust an additional ten (10) years was valid evidence of the extension. Although the court determined that the letter was questionable and did not admit it into evidence so the trust was not found to have been extended, the court's efforts to discredit the letter in its opinion indicate that it perhaps considered the letter would have been effective to extend the irrevocable trust period if it were valid. *See Id.* at 371. The letter from the beneficiary was dated before the date that the trust was to become revocable and sought the permission of the trustee to extend the irrevocable period for an additional ten (10) years. *Id.* at 370. This would seem to amount to an amendment to the trust by the beneficiary and trustee and raises the question whether such an amendment would in fact be enforceable by a bankruptcy court if found to have been a valid amendment made in accordance with the trust terms. Of course, if such an amendment were made under circumstances that could qualify as a fraudulent conveyance, it would likely be set aside in any event.

Another method for long-term creditor protection is to make a trust last the lifetime of at least the primary beneficiary and, to the extent it could be made perpetual without violating the rule against perpetuities, for as long thereafter as possible. Then the provisions of the trust could grant discretion in the trustee to purchase business interests for a beneficiary or allow loans to the beneficiary so that the beneficiary could make use of the trust property without making it subject to his creditors.

6. Family Trusts. Trusts can be set up for any number of different purposes to facilitate a family's estate planning and asset protection planning. As with any trust, the less the beneficial interest retained by a settlor and the weaker any powers of appointment or revocation are, the greater the asset protection that will be afforded. Trusts can be set up to hold family assets and retain an interest much in the same way as a family limited partnership might hold them. But appointing the settlor as trustee and retaining control like a general partner, is too great a risk for the settlor when broad discretionary powers granted to a friendly trustee in an irrevocable spendthrift trust can provide so much more protection. Thus, a settlor might create a spendthrift trust for the benefit of his children into which he makes gifts of property solely for their benefit and retains no right of revocation. In this situation, a parent can act as trustee and retain control of the assets without causing it to be subject to his creditors or the children's creditors. This can also allow him to control the vote of any family-owned business interest held in that trust, the beneficial interests of which will belong to the children, but the control over which will belong to the trustee who owns the remaining interest in the business.

B. Will Drafting. Wills are far and away the most common document used for disposing of one's estate. Although many marketers of legal services have touted the advantages of a living trust for estate planning, the ease with which one can navigate independent administration in Texas has led many practitioners to advise their clients to continue to use wills because of their simplicity and because they do not require any transfer of assets prior to a decedent's death. It should be widely known now that living trusts do not provide any additional estate or gift tax advantages over wills.

1. Avoiding Probate. Nevertheless, there are some differences worthy of note. First, property held in the living trust will avoid probate, even though the settlor's revocation powers cause those properties to be includable in the estate for federal estate tax purposes. This can have some advantages for asset protection purposes. One is that probate provides a mechanism for settlement of debts of the decedent. Even in independent administration, claimants can file claims with the personal representative of the estate, and expect that they will be paid to the extent they are deemed valid and assets are available for their payment. Thus, the probate estate passing under a will will generally be the primary source for payment of debts. By use of non-testamentary transfers (including living trusts) one may at least be able to place certain assets further from a creditor's reach and, perhaps, make more difficult the collection from certain assets. *See ILIT Loans, L.P. v. Estate of Bracher*, 935 S.W.3d 469 (Tex. App. – Houston [14th Dist.] 2002, no pet. h.), where the court refused to decide whether a revocable self-settled trust was available to the settlor's creditors after his death.

Further, costs of ancillary probate in multiple jurisdictions can be a problem when real property is held outside of Texas. Revocable trusts or other non-testamentary transfers can remove those properties from probate and may be helpful in reducing those costs and the need to engage an attorney in that other jurisdiction for ancillary probate.

One disadvantage of avoiding probate is that the probate system in Texas provides for a shorter statute of limitations if proper notice is given to creditors. Texas Probate Code § 294(d) allows an executor to give notice via certified mail, return receipt requested, to a creditor notifying them that all claims must be filed within four (4) months and if the claim is not received in that time period, the claim will be barred.

2. Tax and Debt Payment Clauses. When planning through a will, one may create any manner of irrevocable spendthrift trusts that should be sufficient to protect the interests of any beneficiary from his or her creditors. Of course, such assets will only be protected after funding of the trust, which is subject to the administration of the estate and payment of any of the decedent's debts as provided for in the will. One often overlooked and very important clause in the will is the clause allocating debts and taxes among various assets of the estate. The default tax payment clause of Texas Probate Code § 322A is a pro rata apportionment statute that is commonly used in wills. This provides that all assets of the estate will bear taxes in their proportionate relationship to the entire taxable estate. There are some limited exceptions, for example, generation-skipping taxes are usually allocated only to the property giving rise to that tax. Although pro rata apportionment of taxes seems equitable, this can cause problems with respect to some assets that one would rather not have subject to payment of estate tax. For example, retirement benefits or IRA's that are obligated to pay tax may accelerate distributions from those plans and incur unnecessary income tax upon distribution. On the other hand, recipients of some illiquid property might find the executor first must sell that property or borrow funds to pay the share of the tax related to that property. One should also be careful not to require the payment of a debt secured by one property with other property of the estate. For this reason, it is wise to have a clause subjecting any property that is burdened with a debt to payment of that debt.

One often-used alternative to pro rata apportionment is the direction that all taxes and debts be paid out of the residue of the estate. In an estate plan that heavily utilizes non-testamentary transfers, this can be a disaster. For example, if the vast majority of the estate passes through an IRA, life insurance policy and joint tenancy with right of survivorship accounts, the residue of the estate may be exhausted with the tax burden and payment of debts related to those other properties. This can also lead to severe inequities when some beneficiaries are more heavily favored by non-testamentary assets and others by assets passing under the will. Again, a residuary payment clause will often penalize will beneficiaries more than those receiving non-testamentary assets.

The abatement of bequest provisions of § 322B of the Texas Probate Code sets forth the order of payment of unsecured debts when not provided otherwise in the will. Abatement follows according to the different kinds of property dispositions in the will. Debts are to be paid first out of intestate property, next in order out of (a) residuary personal property, (2) residuary real property, (3) then general bequest of personal property, (4) general devises of real property, (5) specific bequests of personal property, (6) specific devises of real property. TEX. PROB. CODE § 322B(a). Again the allocation of debts may be better addressed in a will provision considering the assets to be transferred and those that are most important to reserve from debts.

3. **Non-Testamentary Assets**. Further, since the estate will be subject to claims of creditors, any non-testamentary transfers requiring beneficiary designations that will avoid the decedent's creditors, should not be left to the estate whenever possible. Thus, a life insurance policy should be left to the spouse or child or a trust for the spouse or child. Note that many insurance policies have clauses providing the estate as the default beneficiary in the event a beneficiary designation is not made by the insured or owner or a designated beneficiary predeceases. The best way to avoid subjecting the policy proceeds to creditors is to have several contingent individual beneficiaries named in the policy or to have the policy owned by a trust or payable to a trust.

A similar problem exists with respect to retirement benefits and individual retirement accounts. Again, one should avoid naming the estate as a beneficiary, not only to avoid creditors of the estate, but also because in some instances, this will greatly accelerate the distributions and income tax on those distributions. For example, if an estate is named as beneficiary of an IRA where the decedent dies before age 70½, the entire IRA will have to be distributed within five (5) years from the year after the decedent's date of death. This will greatly accelerate the distributions and the income tax due on those retirement benefits.

As was discussed earlier, joint tenancy with right of survivorship accounts (pay on death [POD] and Totten Trust accounts) can be considered secondary debt payment sources due to their avoidance of probate. Because these assets will not be subject to the control of the executor, it is important to consider all non-testamentary transfers when allocating taxes and debts in the apportionment clause of any will.

4. **Credit Shelter Trusts and Marital Trusts.** When drawing wills or living trusts for married couples, the estate planner always tries to maximize the use of each spouse's applicable credit amount. This is the amount that can pass free of estate tax and gift tax during one's lifetime and at death due to the unified credit each person is granted to pay the tax on that amount. I.R.C. § 2010 (West 2002). Most married couples will utilize a credit shelter trust (otherwise known as a bypass trust) that is funded by the amount of their applicable credit amount available at death. This is usually retained in an irrevocable trust for the benefit of the spouse for his or her lifetime and thereafter passes to the children, although it can also be available for use of the children during the surviving spouse's lifetime. Bypass trusts can either be funded as a measured amount by formula or as residue of the estate. The balance of the estate generally passes directly to the surviving spouse or in a marital trust, either of which will be entitled to a marital deduction.

Failure to utilize the credit shelter trust in marital planning, will waste the applicable credit amount of the first spouse to die and may lead to unnecessary tax at the death of the second spouse, to the extent the survivor's estate then exceeds the applicable credit amount available.

The applicable credit amount is presently $1,000,000 per spouse and will rise to $1,500,000 per spouse on January 1, 2004. Other increases are scheduled in later years, with repeal of the tax in 2010 and return of the tax at rates in 2011 in effect prior to tax reform.

Obviously, one would want to avail the beneficiaries of the credit shelter trust with all the spendthrift protection that can be afforded such as an irrevocable testamentary trust. The surviving spouse can even be the trustee of this trust while also a beneficiary, provided her discretion for distributions is limited to an ascertainable standard, such as her health, education, maintenance and support. In the absence of an ascertainable standard, the trustee powers afforded the surviving spouse could cause the credit shelter trust to be included in her estate, thus invalidating the purpose for the credit shelter trust. Because the trust would actually be created by the deceased spouse as an irrevocable trust, there should be no self-settled trust issue.

5. **Marital Deduction Trusts**. Many spouses also include spendthrift marital trusts for the marital deduction portion of the estate passing for the benefit of the spouse to achieve the same spendthrift trust protection. One type of marital trust is a QTIP trust that requires annual distributions of income for the life of the spouse but the decedent directs to whom the estate will pass after the death of the surviving spouse. *See* I.R.C. § 2056(b)(7) (West 2002). Another type of marital trust is a life estate with power of appointment trust that allows the spouse to receive income distributions for life and then has a power to appoint the trust property to the surviving spouse or his or her estate. I.R.C. § 2056(b)(5). Because a lifetime power of appointment granted to the surviving spouse would make that trust subject to her creditors, it is preferable to have a power of appointment exercisable only by a will of the surviving spouse. Both kinds of trusts are discussed in I.R.C. § 2056(b). The power of appointment trust can be limited to distributions to the spouse or her estate and should only be exercisable by will. This would certainly be preferable to a general power of appointment during her lifetime, since the lifetime general power of appointment might subject her interest to her creditors.

Because some spouses do not wish to be restricted by an ascertainable standard with respect to principal in such marital trusts, many planners will add a provision entitling the spouse to withdraw each year up to five percent (5%) of the value of the trust or $5,000 (whichever is greater) without any standard for distribution. As discussed above, although the lapse of this power does not make the trust self-settled under the Texas spendthrift rule (TEX. PROP. CODE § 112.035(e) (West 2002)) this power of withdrawal is a general power of appointment that the surviving spouse's creditors could reach to the extent of the *"5 or 5 power"*. When the marital trust continues for the benefit of the children or if a children's trust is created under a will, the credit protection and tax issues identified for *inter vivos* children's trusts discussed above, would also apply to testamentary trusts for the benefit of children, whether as remainderman or as primary beneficiaries.

6. **Disclaimers**. Will drafting for flexibility should always consider the use of disclaimer clauses. A disclaimer clause enables a beneficiary to disclaim or waive any interest in an estate that will treat the disclaiming party as having predeceased the testator and allow the property to pass in an alternative fashion to the successor beneficiaries. This not only has significant advantages in light of ever-changing tax laws and ever-changing estate property, but can also have significant creditor protection advantages. Generally, a disclaimer clause provides that in the event a beneficiary's interest is disclaimed, it will pass to some other beneficiary or asset protection trust under the will. When a spouse exercises a disclaimer, it is possible to have the property nevertheless pass in some other manner to the spouse, including to a trust in which the spouse is a beneficiary. I.R.C. § 2518(b)(4)(A) (West 2002). TEX. PROB. CODE § 37A (West 2002). Other testamentary beneficiaries, are not afforded this opportunity, as the disclaimer statute requires that they not share any interest in the disclaimed property even as a beneficiary of a successor trust receiving the property. I.R.C. § 2518(b)(4)(B). TEX. PROB. CODE § 37A(f). Fortunately, all beneficiaries can partially disclaim some assets of the estate or various interests in an estate distribution but retain other interests. *See* TEX. PROB. CODE § 37A(e) and I.R.C. § 2518(c). Thus, a child could disclaim an automatic income distribution right from a trust but retain the right to discretionary corpus distributions. This could prevent his creditors from getting his income interests and the discretionary interests under a spendthrift trust.

It is also clear that creditors are not entitled to any asset properly disclaimed by a debtor. *See Dyer v. Eckols,* 808 S.W.2d 531 (Tex. App. – Houston [14th Dist.] 1991, writ dism'd). This is primarily because the disclaimer relates back to the date of the transfer or for an estate, the date of the transferor's death. This also means that the disclaimant did not make a fraudulent transfer by disclaiming, since he typically had no interest to transfer. This was codified in § 37A of the Texas Probate Code which states "a disclaimer evidenced as provided herein shall be effective as of the death of the decedent and shall relate back for all purposes to the death of the decedent and is not subject to any claims of any creditor of the disclaimant." TEX. PROB. CODE § 37A.

Beneficiary disclaimers have also been upheld after a turnover order had been entered against the disclaimant (*Parks v. Parks*¸ 957 S.W.2d 666 (Tex. App. – Austin, 1997) and on the eve of filing for bankruptcy (*Matter of Simpson,* 36 F.3d 450 (5th Cir. 1994). Unfortunately, it has been held that a disclaimer does not defeat a federal tax lien. *See Drye v. United States,* 528 U.S. 49 (1999).

To make a qualified disclaimer, the disclaimant must:

1. Sign a written disclaimer identifying the interest disclaimed.

2. Specify that the disclaimer is irrevocable.

3. Deliver the written disclaimer to the transferor of the interests or the legal representative (such as an executor) or the legal titleholder to the property (such as a trustee) within the disclaimer period. The disclaimer period is nine (9) months after the date on which the transfer creating the interest in the disclaimant is made (such as the date of death of the decedent) or, if later, nine (9) months from the day on which the disclaimant turns age twenty-one (21). Special rules identifying the creation date of certain disclaimable interests might need to be consulted. In Texas, the disclaimer must be filed in the probate court in which the estate is pending for a transfer upon the death of a decedent.

4. Not accept any of the property disclaimed and not direct to whom the property is to be distributed. In the event a disclaimer is found not to be qualified for disclaimer treatment, the effect of the disclaimer is to result in the acceptance of the property by the disclaimant and an assignment in favor of those who receive pursuant to the disclaimer.
See I.R.C. § 2518 (West 2002) and TEX. PROB. CODE § 37A (West 2002).

C. Partnerships and Limited Liability Companies. Both limited partnerships and limited liability companies in Texas share similar asset protection advantages. There are, of course, several important differences, many of which relate to the manner in which those entities are formed and the governing documents. Limited partnerships in Texas are governed by the provisions of the Revised Uniform Limited Partnership Act as adopted in Texas, that is known as the Texas Revised Limited Partnership Act and may be found at Article 6132a-1 (Vernon 2003). Limited liability companies are a more recent development and are governed by the Texas Limited Liability Company Act, Article 1528n (Vernon 2003).

One significant difference between limited partnerships and limited liability companies in Texas, is that limited partnerships, for the time being, are not subject to state franchise taxes, while limited liability companies are subject to state franchise taxes. *See* TAX CODE § 171.255 (Vernon 2003). Another notable difference is that limited liability companies have only been authorized in Texas since September 1, 1997 and similar acts have not been adopted in all fifty (50) states. Thus, there is less uniformity of laws among the states with respect to limited liability companies, than there are with limited partnerships. Also, because of the longer time that limited partnerships have been subject to challenge by creditors trying to reach assets of partners and by the IRS seeking to undermine certain tax-planning advantages achieved through partnerships, there is a greater body of law on which an estate planner can rely when advising clients. For these reasons, many practitioners prefer the use of limited partnerships as the limited liability entity of choice when seeking to protect assets from creditors.

The balance of this section of the outline will primarily discuss limited partnerships, though specific statutory provisions on asset protection features of the Limited Liability Company Act will be discussed. It is assumed that most of the asset protection benefits enjoyed by partners of limited partnerships will also be enjoyed by members of limited liability companies in Texas.

1. Charging Order (Outside Liability Protection). The protection afforded by limited partnerships is not as absolute as an irrevocable spendthrift trust. Rather, it is by the statutory limitation of a creditor's right to pursue the interests of a partner in a partnership. This is known as the *"charging order concept"* and is almost universal among limited partnership statutes in the various states. In Texas, the charging order concept is codified in article 6132(a)-1, § 7.03 that states:

> **(a)** "On application to a court of competent jurisdiction by a judgment creditor of a partner or of any other owner of a partnership interest, the court may charge the partnership interest of the partner or other owner with payment of the unsatisfied amount of the judgment, with interest, may then or later appoint a receiver of the debtor partner's share of the partnership's profits and of any other money payable or that becomes payable to the debtor partner with respect to the partnership and may make all other orders, directions and inquiries that the circumstances of the case require. To the extent that the partnership interest is charged in this manner, the judgment creditor has only the rights of an assignee of the partnership interests.
>
> **(b)** The partnership interest charged may be redeemed at any time before the foreclosure, or in case of a sale directed by the court, may be purchased without a dissolution being caused:
>
> **(i)** with separate property of any general partner, by any one or more of the general partners; or
>
> **(ii)** with respect to partnership property by any one or more of the general partners whose interests are not charged, on the consent of all general partners whose interests are not charged and the majority in interest of the limited partners, excluding limited partners' interests held by any general partner whose interest is charged.
>
> **(c)** The remedies provided by sub-section (a) of this section are exclusive of others that may exist, including remedies under laws of this state applicable to partnerships without limited partners.
>
> **(d)** This section does not deprive any partner of the benefit of any exemption laws applicable to that partner's partnership interest." Texas Revised Limited Partnership Act, art. 6132a-1, § 7.03 (*emphasis added).*

The charging order concept for limited liability companies in Texas appears in article 4.06 of the Texas Limited Liability Company Act that reads as follows:

> "Art. 4.06. A. On application to a court of competent jurisdiction by a judgment creditor of a member or any other owner of a membership interest, the court may charge the membership interest of the member or other owner with payment of the unsatisfied amount of the judgment. Except as otherwise provided in the regulations to the extent that the membership interest is charged in this manner, the judgment creditor has only the rights of an assignee of the interests. This section does not deprive any member of the benefit of any exemption laws applicable to that member's membership interest."

(*Emphasis added)* Texas Limited Liability Company Act, article 4.06 (West 2002).

The significance of the charged partnership interest being limited to the rights of an assignee cannot be understated. Section 7.02 of the Texas Revised Limited Partnership Act addresses the rights of an assignee and provides in subsection (3), "…an assignment entitles the Assignee to be allocated income, gain, loss, deduction, credit or similar items, and to receive distributions, to which the assignor was entitled, to the extent those items are assigned*…*" Sub-paragraph (4) of § 7.02 continues by stating "….until the Assignee becomes a partner, the assignor partner continues to be a partner and to have the power to exercise any rights or powers of a partner…" Thus, the assignee has no rights to vote shares, as those are reserved by the assignor partner. Further, if the general partner elects within his authority not to make distributions of income to the partners, the assignee will receive nothing.

Even worse, because the partnership is a pass-through taxable entity, its income will pass through and be taxable to the interest holder entitled to the income, in this case, the assignee. The IRS has held an assignee of a partnership interest to be taxable on the income, loss, gain, deduction and credit attributable to the assigned interest as though the assignee were a substitute limited partner. Rev. Rul. 77-137, 1997-1 C.B. 178. Although this ruling did not involve an involuntary assignment through a charging order, it is likely that the same result would be obtained for a charging order interest, which certainly makes the assignee interest in the partnership much less attractive to a creditor who has no control over distributions or taxable income of the partnership. *See* Leonard L. Silverstein, et al, *Asset Protection Planning*, 810 SECOND TAX MANAGEMENT PORTFOLIOS at 40-41.

The rights of an assignee under the Limited Liability Company Act only entitle him "…to be allocated income, gain, loss, deduction, credit or similar items, and to receive distributions to which the assignor was entitled, to the extent those items are assigned, and, for any proper purpose, to require reasonable information or account of transactions of the limited liability company and to make reasonable inspection of the books and records of the limited liability company." Texas Revised Limited Partnership Act, article 4.05A(3) (West 2002). Here, the assignee is entitled to reasonable inspection of books and records, which assignees of limited partnerships do not appear to be entitled to receive. Further, with respect to both limited partnerships and limited liability companies, the governing agreements can provide additional benefits to assignees. For this reason, it is very important that the drafters of such limited liability entities not vary from the strong statutory protections limiting assignee interests.

The statute clearly intends to make a charging order the exclusive remedy for a creditor of a partner. Notwithstanding this exclusive remedy language, some creditors seek a turnover order for collection of judgments under § 31.002 of the Texas Civil Practice & Remedies Code to receive a limited partnership interest of a judgment debtor—partner. Even so, the interest turned over would seem to also be limited to the interest of an assignee.

(a) **Exceptions to Charging Order Protection.** Although this author has not seen Texas cases successfully expanding a creditor's foreclosure rights to exceed an assignee interest, there are cases in other jurisdictions that seem to erode the charging order protection. These cases seem to turn on factors such as (1) a fraudulent transfer to the limited partnership where the partner's interest received was not of equivalent value, or (2) the limited partnership lacked business purpose and should be disregarded, or (3) sale of the partnership interest when it was agreed by all other partners in accordance with the partnership agreement. *See Leonard* L. Silverstein, et al, "*Asset Protection Planning*", 810 Second Tax Management Portfolios at A-39, 40. To counter these cases, if such exceptions were ever to be applied in Texas, one would do well to adhere to fraudulent conveyance laws, and to respect the business entity when forming and operating a limited partnership.

There are many valid business purposes for establishing a family limited partnership that one might do well to document in correspondence with the client so as to diffuse arguments that the partnership was only created to avoid creditors. These business purposes include (i) maintenance of partnership assets within the family or other close group of partners, (ii) control over distributable cash flow, (iii) consolidation of investments that benefit from economies of scale and overall cost savings, (iv) simplification of record keeping, (v) consolidation of insurance protection for cost savings among the properties contributed, (vi) simplification of annual giving planning among the partners, (vii) avoidance of ancillary probate for out-of-state property, (viii) succession planning for governance, (ix) where applicable, providing for arbitration to resolve disputes among partners, and (x) otherwise allowing for the necessary and proper management of partnership assets. For a review of operational rules that should be followed to maintain the business nature of the partnership, consult Appendix I, attached to this outline. Appendix I summarizes operational rules that can be gleaned from recent cases in which the IRS has been successful in challenging partnerships for the lack of proper formation and operation as a separate business entity from the assets of the partners.

2. Inside Liability Protection. Of course, like other limited liability entities, the limited liability company and the limited partnership are afforded protection against claims inside the partnership. The personal exposure of partners or members, as appropriate, is generally limited to his investment in the entity. Article 4.03 A of the Limited Liability Company Act provides "Except as and to the extent the regulations specifically provide otherwise, a member or manager is not liable for the debts, obligations or liabilities of the limited liability company including under a judgment, decree or order of the court." Limited Liability Company Act, art. 403(A) (West 2002). Similarly, the Texas Revised Limited Partnership Act at § 3.03(a) provides "except as provided by subsection (d) of this section, a limited partner is not liable for the obligations of a limited partnership unless the limited partner is also a general partner…" Limited Liability Company Act, art. 4.03(B) (West 2002). Here, the limited partner may be liable, if he acts as a general partner or has control similar to a general partner as otherwise provided in that section. For this reason, limited partnerships generally provide a limited liability entity as the general partner of the partnership to insulate themselves personally from that liability. Such entities of choice for general partners are usually "S" corporations or limited liability companies.

In some cases, it is advisable for assets to be held by multiple limited liability entities, where there is a possibility for claims arising separately from those properties.

In this way, liabilities arising from one property could only reach the assets of that limited liability entity and this would insulate the other limited liability entities and their properties from those claims. Both limited partnerships and limited liability companies can own other limited liability entities in this manner. In such cases, the general partners of the multiple limited partnerships are usually the same limited liability company or corporation.

3. **Formation of the Limited Liability Company.** Assuming it has been decided that transfers to a limited liability entity would be advantageous both for asset protection planning purposes and for state and gift tax planning purposes, the structure of that entity would generally take the following form. First, a limited liability company (or "S" corporation, if preferred) is formed to be the general partner of the limited partnership. Regulations are drawn for the members and articles of organization are filed with the Secretary of State. Once formed, the general partner, acting through its officers, managers or members, as appropriate, executes a limited partnership agreement with the limited partners. Each partner should receive an interest in the partnership equal to the value of the property contributed. The general partner, often contributes cash only and may receive a minimal share of the partnership to reduce risks associated with franchise taxes and the chargeable income interest a creditor might obtain. Before the "check-the-box" rules were adopted by the Internal Revenue Service, it was common to have a one percent (1%) or greater interest in the general partner so that the general partner had a substantial interest as was required to avoid taxation as a corporation. Now, it is possible to have a tenth of a percent (.1%) and some practitioners even use a one-hundredth of a percent (.01%) interest in the general partner to minimize any economic disadvantage of a larger interest. Since the partnership agreement empowers the general partner with all management powers of the partnership, regardless of the size of its interest, many practitioners believe the smaller the interest the better.

4 **Formation of the Limited Partnership**. Once the limited partnership agreement has been completed, the general partner files a Certificate of Limited Partnership with the Secretary of State. Assets may then be contributed to the partnership in accordance with the partnership agreement, and partnership interests exchanged according to the value of those contributions.

When drawing the partnership agreement and the regulations for the limited liability company, care should be taken to avoid automatic distributions of income or other provisions minimizing discretion in the general partner, since that will enable the partnership to be less attractive to a creditor seeking a charging order. Discretion in partnership distribution provisions used for asset protection purposes, however, may run counter to the tax cases finding that a partnership was not properly formed and operated when the individual general partner also held nearly all of the limited partnership interests. The IRS has argued successfully in such cases that a taxable interest was retained, because there was no real change in the manner in which the transferor's assets were held and he retained all of the same interests and control before and after the transfer to the partnership. *See* Appendix I.

5. **Estate and Gift Tax Issues.** Once the limited partnership is formed, several other estate planning advantages will arguably flow from it. First, it is widely

held that valuation discounts are applicable to limited partnership interests because of their lack of marketability, minority interests, and inability to reach the assets of the partnership or control distribution of partnership income. In order to take full advantage of these potential discounts, it is important that the partnership agreement and any LLC regulations be drawn to take advantage of these discounts with these restrictions. It is also important to hire a qualified valuation expert to review the agreements and to prepare a formal valuation. This is particularly true if the discounts are to be used for estate tax return purposes to evidence the reduced value for the deceased partner's interest, or to reduce the value for gift tax purposes.

Limited partnership interests can make excellent gifts if the limited partners wish to employ an annual gift plan. Because of the valuation discount, larger annual gifts can be made to children or other beneficiaries within the annual exclusion cap (presently $11,000 per year per donee/donor). Otherwise, the partnership discounts allow donors to use less of their applicable credit amount if the annual gifts exceed the annual gift tax exclusion. With respect to the annual gift exclusion, note that the IRS has been somewhat successful arguing that a partnership interest is not a present interest (and therefore not entitled to the annual gift tax exclusion) when the partnership is controlled by the donor and there is no other present right to receive income from the partnership other than in the discretion of the donor. *See Hackl v. C.I.R.*, 2003 WL 21557582 (7th Cir. 2003)

When drafting the limited liability entity document one should consider sharing management duties among multiple partners by giving them interests in the general partner entity, since recent IRS attacks on limited partnerships have focused on the sole control of an individual donor as general partner.

Still, the greatest threat to family limited partnerships appears to be the IRS's recent success in arguing that the partnership contributions constitute a transfer with a retained interest under I.R.C. § 2036 because (i) nearly all of the decedent's estate was transferred, (ii) the decedent retained control and received the same benefits as before, and, (iii) the partners ignored the separate business entity characteristics of the partnership. In those cases when the IRS successfully argued this view, all of the partnership assets contributed by the decedent were included in his estate at their full value, without the partnership discount. *See Estate of Strangi v. C.I.R.*, 115 T.C. 478 (2000). For a more thorough analysis of the cases arguing inclusion in § 2036 and ways to avoid it, *see* Appendix I.