

# **ASSET PROTECTION PLANNING IN ESTATE PLANS**

By Ellen Kaufman Wolf<sup>1</sup>

Estate planning and asset protection planning are both important, obviously. But the question is, can they overlap and intertwine? Asset protection planning is best before a client has creditors in pursuit. Often, asset protection planning can be better accomplished for a client's heirs than for the client. The considerations are multi-faceted, and requires careful tax planning consideration, as financial planning, gift tax, estate tax and income tax (capital gains and/or basis step-up) may all be implicated at once. Not for the faint of heart, and definitely not to be done without adequate expertise and tax advice.

Among other estate planning strategies, certain trusts and partnerships or limited liability companies can be used for asset protection planning.

## **A. ASSET PROTECTION FOR TRUSTOR WITHOUT EXISTING CREDITORS**

### **1. Family Limited Partnership:**

The family limited partnership entity can place assets in a non-transferrable structure that a creditor cannot reach, as a practical matter. Often, family partnership agreements will restrict transferability, and/or provide buyout provisions by which any other partner can buy out the debtor partner's interest on an appraised value, which could a) consider valuation adjustments (discounts for lack of marketability and lack of control<sup>2</sup>), and/or b) long payout terms (and maybe only periodic, e.g., annually or bi-annually), on a promissory note at an interest rate attractive to the buyer. The debtor might also purchase and cross-collateralize on the payment stream other additional illiquid or highly leveraged assets, which would pose an additional obstacle, perhaps insurmountable, for the creditor. .

### **2. Transfer (Gift Or Sale) To Irrevocable Trust**

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<sup>2</sup> New regulations have been proposed to disallow minority discounted valuations in certain intra-family transfers. See attached "Proposed IRS Regulations Re Minority Discounts," pertaining to Section 2704 of the Internal Revenue Code, which provides special valuation rules for purposes of subtitle B (relating to estate, gift, and GST taxes) for valuing intra-family transfers of interests in corporations and partnerships subject to lapsing voting or liquidation rights and restrictions on liquidation.

When there are no existing creditors, a Trustor may decide to transfer assets to an irrevocable trust, either by gift or sale. These assets are thus preserved for the debtor's family or heirs, come what may.

This decision requires careful tax planning consideration, as gift tax and income tax (capital gains and/or basis step-up) may be implicated. In a grantor trust, (see IRC Section 671 through 679), the funded assets are out of the trustor's estate, but the grantor typically has an income stream via a purchase money promissory note, and retains certain powers or ownership interests so that the trust is disregarded for income tax purposes. Income, deductions and credits are reported on the grantor's individual tax return (and thus paid by the grantor.)

Transfers may be fractionalized before transfer, for possible discounted valuations. (See footnote 2).

Transfer by sale to a grantor trust does not implicate immediate capital gains taxes, because a grantor trust is a disregarded entity for income tax purposes. The sale is usually made pursuant to a promissory note, no less than the minimum AFR interest rate, which results in an income stream back to the trustor. The promissory note payment terms can be on long payout terms that would not be attractive for a creditor to attempt to collect. (Interest rate cannot be less than Minimum AFR rate.) If a creditor later appears on the horizon, the trustor may decide to borrow against the income stream and assign or encumber the payment stream in favor of such lender. If the borrowed money is then used to buy another illiquid asset with little equity, a creditor will again find it unattractive to pursue.

## **B. ASSET PROTECTION FOR HEIR(S) – DOMESTIC TRUSTS**

A money judgment may be enforced against an interest in a trust. (§ 695.030, subd. (b)(1).) In general, any property of the judgment debtor that is subject to enforcement of a money judgment is subject to levy under a writ of execution under section 699.710. (§ 699.710 [“Except as otherwise provided by law, all property that is subject to enforcement of a money judgment . . . is subject to levy under a writ of execution to satisfy a money judgment”].)

However, the Legislature specifically excluded interest in a trust from levy by writ of execution. (§ 699.720, subd. (b) [“The following types of property are not subject to execution . . . [t]he interest of a trust beneficiary”].) Instead, a judgment creditor must utilize the enforcement procedures set out under section 709.010 to reach the interest of a trust beneficiary.

By its plain terms, the enforcement procedures of Code of Civil Procedure section 709.010 are the only means available for a judgment creditor to enforce a money judgment against an interest in a trust. (Code Civ. Proc., § 709.010, subd. (b) [“The judgment debtor’s interest as a beneficiary of a trust is subject to enforcement of a money judgment only upon petition under this section . . .”, italics added].) Moreover a judgment creditor may file a petition only with “a court having jurisdiction over administration of the trust. . . .” *FirstMerit Bank v. Diana Reese*, E061480.

Under a proper petition, “[t]he judgment debtor’s interest in the trust may be applied to the satisfaction of the money judgment by such means as the court, in its discretion, determines are proper, including but not limited to imposition of a lien on or sale of the judgment debtor’s interest, collection of trust income, and liquidation and transfer of trust property by the trustee.” *FirstMerit Bank v. Diana Reese*, E061480. Provisions of the Probate Code impose, under certain circumstances, limits on a judgment creditor’s right to collect from a trust. (Code Civ. Proc., § 709.010, subd. (c).) Creditors will continue to have a very difficult time obtaining a debtor’s interests in a trust.

Code of Civil Procedure Section 709.010 provides:

(a) As used in this section, "trust" has the meaning provided in Section 82 of the Probate Code.

(b) The judgment debtor's interest as a beneficiary of a trust is subject to enforcement of a money judgment only upon petition under this section by a judgment creditor to a court having jurisdiction over administration of the trust as prescribed in Part 5 (commencing with Section 17000) of Division 9 of the Probate Code. The judgment debtor's interest in the trust may be applied to the satisfaction of the money judgment by such means as the court, in its discretion, determines are proper, including but not limited to imposition of a lien on or sale of the judgment debtor's interest, collection of trust income, and liquidation and transfer of trust property by the trustee.

(c) Nothing in this section affects the limitations on the enforcement of a money judgment against the judgment debtor's interest in a trust under Chapter 2 (commencing with Section 15300) of Part 2 of Division 9 of the Probate Code, and the provisions of this section are subject to the limitations of that chapter.

In a recent case, it was held that an assignment order cannot reach a debtor’s beneficial interests in a trust. In November 2015, the court re-affirmed the protections that can be afforded by a trust in *FirstMerit Bank v. Diana Reese*, E061480 (“FirstMerit case”). The creditor applied for an assignment order under Code of Civil Procedure Section 708.510(a). The court held that an assignment order is an inappropriate remedy to obtain distributions from a trust, which instead must be reached exclusively under Code of Civil Procedure Section 709.010.

The creditor argued that, “notwithstanding section 709.010, it is permitted to utilize the assignment procedures set out in section 708.510 to obtain “an order directing

[debtor] to assign and turnover payments distributed to her from a third party trustee.” Such an order would not require jurisdiction over the trustees because it would direct “assignment of [debtor’s] right to receive payments of the Trusts *once they are disbursed by the Trustee.*” (Italics added.)”

The court rejected that argument as ignoring “the nature of an assignment. An “assignment merely transfers the interest of the assignor. The assignee ‘stands in the shoes’ of the assignor, taking his or her rights and remedies, subject to any defenses that the obligor has against the assignor prior to notice of the assignment.” ... Thus, in seeking an assignment order under section 708.510, [the creditor] sought to acquire [debtor’s] rights to receive payments from [debtor’s] trustees. ... That result is precisely what the Legislature precluded by enacting exclusive procedures for enforcing money judgments against trusts. (§ 709.010, subd. (a).) Those exclusive procedures allow a court to apply a judgment debtor’s interest in a trust “to the satisfaction of the money judgment by,” among other means, “collection of trust income,” but only if the court has jurisdiction over the administration of the trust. (§ 709.010, subd. (b).)”

The court also rejected a “turnover” order of the trust funds received by the debtor, saying that the creditor would need to levy on the funds “pursuant to a writ of possession.” (Perhaps the court meant to say “pursuant to a writ of execution.”)

So, creditors are left with only remedies under Code of Civil Procedure Section 709.010, which requires a court petition and hearing to be decided in the probate court’s discretion as to whether and how to satisfy the judgment from the debtor’s interest in a trust. The real rub there is that most trusts (other than revocable, or inter vivos, trusts) are “spendthrift trusts” – which provide that the beneficiary’s interest cannot be voluntarily or involuntarily transferred.

### **1. Spendthrift Trust**

Spendthrift trusts are **not** generally subject to enforcement of a money judgment unless the debtor beneficiary is also the settlor, or the judgment is for spousal or child support, criminal restitution, reimbursement of public support furnished to a spouse or child of the debtor.

But even spendthrift trusts can result in certain recovery to a creditor. The court can order the trustee to pay to the creditor:

- ✓ up to 25% of the amounts which the trustee has determined to distribute to debtor (Probate Code Section 15306.5), OR
- ✓ other amounts which the trustee has determined to distribute to debtor in excess of the debtor’s education and support (Probate Code Section 15307).

Needless to say, the larger the excess in the trust for debtor's benefit, the better the creditor's chances might be at obtaining this type of court order. With both the court and the trustee having discretion of their respective decisions, recovering from a spendthrift trust is an uphill battle for a creditor.

## **2. Out-of-State Trust Not Subject to California Jurisdiction:**

The court in *FirstMerit* pointed out that Code of Civil Procedure Section 709.010 requires a California court to have jurisdiction over the trust administration (e.g., the trustees and/or the *res*) in order to make the trust pay money towards satisfaction of the California judgment. Code of Civil Procedure Section 709.010 provides: “The judgment debtor's interest as a beneficiary of a trust is subject to enforcement of a money judgment **only upon petition under this section by a judgment creditor to a court having jurisdiction over administration of the trust** as prescribed in Part 5 (commencing with Section 17000) of Division 9 of the Probate Code.

### Probate Code Jurisdiction Sections

17002.

(a) The principal place of administration of the trust is the usual place where the day-to-day activity of the trust is carried on by the trustee or its representative who is primarily responsible for the administration of the trust.

(b) If the principal place of administration of the trust cannot be determined under subdivision (a), it shall be determined as follows:

(1) If the trust has a single trustee, the principal place of administration of the trust is the trustee's residence or usual place of business.

(2) If the trust has more than one trustee, the principal place of administration of the trust is the residence or usual place of business of any of the cotrustees as agreed upon by them or, if not, the residence or usual place of business of any of the cotrustees.

17003. Subject to Section 17004:

(a) By accepting the trusteeship of a trust having its principal place of administration in this state the trustee submits personally to the jurisdiction of the court under this division.

(b) To the extent of their interests in the trust, all beneficiaries of a trust having its principal place of administration in this state are subject to the jurisdiction of the court under

this division.

17004. The court may exercise jurisdiction in proceedings under this division on any basis permitted by Section 410.10 of the Code of Civil Procedure. [*Ed. Note: Long-Arm Jurisdiction coextensive with Constitutional limits.*]

### **3. Dynasty (Life Estate) Trust**

Code of Civil Procedure Section 709.020 provides for creditors to have access to a debtor's contingent remainder or other executory interest in a trust.

709.020. The judgment creditor may apply to the court on noticed motion for an order applying to the satisfaction of a money judgment a contingent remainder, executory interest, or other interest of the judgment debtor in property that is not vested in the judgment debtor. The interest of the judgment debtor may be applied to the satisfaction of the money judgment by such means as the court, in its discretion, determines are proper to protect the interests of both the judgment debtor and judgment creditor, including but not limited to the imposition of a lien on or the sale of the judgment debtor's interest.

A dynasty-type trust, in which the debtor has only a life estate, can provide protection from creditor's exertion of a lien or levy on trust assets under this provision.<sup>3</sup>

## **C. ASSET PROTECTION IN ESTATE PLANNING WITH EXISTING CREDITORS**

### **1. Limited Liability Companies**

Moving assets into a limited liability company can afford some asset protection, and is not a fraudulent transfer so long as the debtor receives reasonably equivalent value for the transfer (which includes membership interests in the limited liability company of equal value to the transfer).

Generally speaking, a creditor cannot reach assets of a limited liability company in which the debtor holds an interest. A creditor can only obtain a charging order, which allows the creditor to receive any distribution from the limited liability company that would be made to the debtor. Corporations Code § 17705.03. Provided substantial

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<sup>3</sup> **Strategies for asset protection and careful tax planning are interwoven and often not mutually complementary. Proceed only with adequate expertise.**

distributions do not have to be made from the limited liability company, the creditor may have little to gain in pursuing such assets.

Corporations Code § 17705.03(f) provides: “This section provides the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of judgment creditor, satisfy the judgment from the judgment debtor's transferable interest.”

Corporations Code Section 17705.03.

- (a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor.
- (b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subdivision (a), the court may do any of the following:
- (1) Appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made.
  - (2) Make all other orders necessary to give effect to the charging order.
  - (3) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale obtains only the transferable interest, does not thereby become a member, and is subject to §17705.02.
- (c) At any time before foreclosure under paragraph (3) of subdivision (b), the member or transferee whose transferable interest is subject to a charging order under subdivision (a) may extinguish the charging order by satisfying the judgment and filing a certified copy of the satisfaction with the court that issued the charging order.
- (d) At any time before foreclosure under paragraph (3) of subdivision (b), a limited liability company or one or more members whose transferable interests are not subject to the charging order may pay to the judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order.
- (e) This title does not deprive any member or transferee of the benefit of any exemption laws applicable to the member's or transferee's transferable interest.
- (f) This section provides the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of judgment creditor, satisfy the judgment from the judgment debtor's transferable interest.

## **2. Sale to Grantor Trust**

If a creditor already exists, debtor may still sell to a Grantor Trust, provided the debtor receives reasonably equivalent value. Fractionalized interests are best for this purpose, for possible discounted valuations. (See, footnote 2 and footnote 3.) Be sure to obtain appraisals (as would be done for estate planning, regardless of the asset protection purposes).

The sale would be made pursuant to a promissory note, no less than the minimum AFR interest rate, which would result in an income stream back to the trustor. The promissory note payment terms can be on long payout terms that would not be attractive for a creditor to attempt to collect. (Interest rate cannot be less than Minimum AFR rate.) The trustor may also decide to borrow against the income stream, and assign or encumber the payment stream in favor of such lender. Especially if the borrowed money is then used to buy another illiquid asset with little equity held in an LLC, a creditor will again find it unattractive to pursue.