

Domestic Asset Protection Trusts: Key Strategies for 2013

Leveraging DAPTs, Combining with Double LLCs,
Navigating Jurisdictional Differences, and Understanding Limitations of Mortensen

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Today's faculty features:

Steven J. Oshins, **Oshins & Associates**, Las Vegas, Nev.

Robert S. Keebler, Partner, **Keebler & Associates**, Green Bay, Wis.

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Domestic Asset Protection Trusts

**Leveraging DAPTs, Combining with Double LLCs,
Navigating Jurisdictional Differences and Analyzing
Limitations of Mortensen**

Steven J. Oshins, Esq., AEP (Distinguished)

Oshins & Associates, LLC

1645 Village Center Cir., Ste. 170

Las Vegas, NV 89134

Phone: 702-341-6000

Fax: 702-341-6001

Website: www.oshins.com

Email: soshins@oshins.com

Robert S. Keebler, CPA, MST, AEP (Distinguished)

Keebler & Associates, LLP

420 S. Washington St.

Green Bay, WI 54301

Direct: 920.593.1701

General: 920.593.1700

Fax: 920.593.1717

Robert.Keebler@KeeblerandAssociates.com

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Asset Protection Planning

- Asset protection planning is a form of insurance
 - You insure your car
 - You insure your house
 - You insure your health
 - You insure your life
 - So you should also “insure” your assets
- Our goal is to structure your assets to either:
 - Avoid a lawsuit altogether; or
 - Settle a dispute for less than what is owed



Fraudulent Conveyances

- It is extremely important for our clients to do their asset protection planning well before being served with a lawsuit or threatened with a lawsuit
- Two types of people
 - Those who have been sued or been through a bad divorce
 - Those who have never been sued or been through a bad divorce



Domestic Asset Protection Trust

- A DAPT is a U.S. asset protection trust in which the trust grantor is a permissible beneficiary
- After a period of time (the statute of limitations), those assets are protected from the grantor's creditors
- Fifteen states allow DAPTs
- Thirty-five states and Washington, D.C. do not allow them



Statute of Limitations

- We want to use the laws of a state that has a short statute of limitations
 - 1.5-yr. statute of limitations – Ohio
 - 2-yr. statute of limitations – Nevada, South Dakota, Utah and Hawaii
 - 4-yr. statute of limitations – All other states
 - 5-yr. statute of limitations – Virginia
- Preexisting creditors versus non-preexisting creditors
- Fraudulent conveyance laws – transfer with the intent to hinder, defraud or delay



Statutory Exception Creditors

- Thirteen of fifteen states have statutory exception creditors
 - Such as divorcing spouses
 - Such as preexisting tort creditors
- Nevada/Utah = only states with no statutory exception creditors



Ranking the States' DAPT Laws

- Forbes Magazine published an article on DAPTs in 2010 assigning letter grades as follows:

Domestic Asset Protection Trusts As Seen In Forbes Forbes.com - July 21, 2010	
A+	Nevada
A	Alaska
A-	South Dakota
A-	Delaware
B	Tennessee
B	Rhode Island
B-	New Hampshire
C	Wyoming
C	Utah
C-	Missouri
C-	Oklahoma
D	Colorado

*Chart prepared by Oshins & Associates, LLC

The Big Four Asset Protection Trust States: Nevada Ranked #1



Ranking/ Forbes Grade	State	Statute of Limitations?	Available to Spouse Creditor?	Available to Pre-existing Tort Creditor?	State Income Tax?
1/A+	Nevada	2 Years	No	No	No
2/A-	South Dakota	2 Years	Yes (Divorcing Spouse, Alimony, Child Support – if debt at time of transfer)	No	No
3/A	Alaska	4 Years	Yes (Divorcing Spouse)	No	No
4/A-	Delawar e	4 Years	Yes (Divorcing Spouse, Alimony, Child Support)	Yes	No (Just on Residents)



Just How Good is Nevada Law?

- "It would be a cruel and unwanted result if someone from a non-DAPT state chose to set up a DAPT in Alaska or Delaware and had a creditor reach the DAPT assets more than two years after the transfer. So an attorney advising a client on where to set up a DAPT may be risking a malpractice claim by not making a client aware of the Nevada advantage."

-Robert L. Moshman, Esq., *The Estate Analyst* (Nov. 2010)



Nevada Asset Protection Trust - Powers

- Grantor can be an investment trustee per NRS 166.040.3
- Grantor cannot be distribution trustee per NRS 166.040.2(b)
- At least one trustee must be Nevada natural person, trust company or bank per NRS 166.015.2
- Grantor can retain power to fire and hire trustees per NRS 166.040.3
- Grantor can retain veto power and testamentary POA per NRS 166.040.2(a)

Second Wall of Defense

- What happens if the NAPT doesn't work because the two-year SOL hasn't run or for any other reason?
- Let's add a second wall so the creditor has to bust through two walls to get the assets
- The second wall is formed using a charging order protected entity such as an LLC or LP
 - See next slide



Charging Orders – LLCs/LPs

- What is a charging order?
- Pick a state where the charging order is the exclusive remedy
- What if the state statute allows a foreclosure of the charged interest?
- Equitable remedies
 - See next slide



Equitable Remedies

- Not all sole remedy states have language saying that no equitable remedies apply
- Examples of equitable remedies
 - Reverse veil piercing – opposite of veil piercing
 - Constructive trust – unjust enrichment
 - Resulting trust – entity holding on behalf of
 - Alter ego – no business purpose / personal assets
- Nevada 2011 legislative session – SB405 says no equitable remedies apply

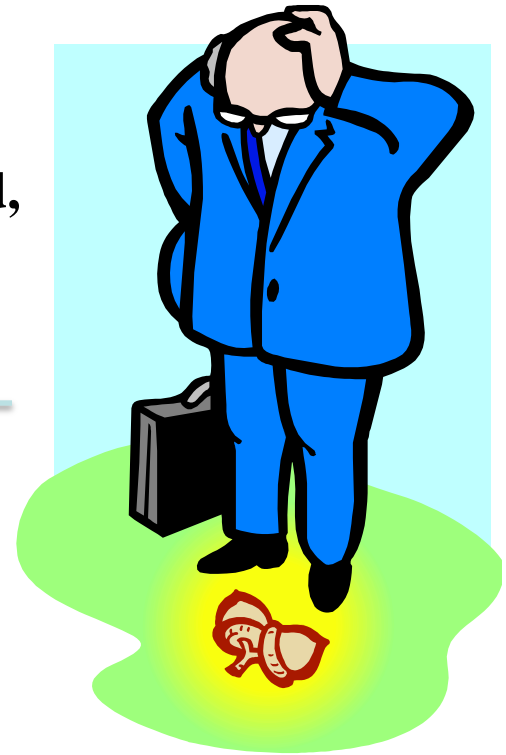
Mortensen in Perspective



AS Chicken Little was going one day to the wood, whack! an acorn fell from a tree on to his head.

"Gracious goodness me!" said Chicken Little, "the sky must have fallen; I must go and tell the King."

The issue is whether the sky is falling on DAPTs or whether Mortenson was a single acorn on a very windy day.



Facts of Mortensen



- **1994 – Mortensen & Spouse buy real property near Seldovia, AK**
- **1998 – Mortensen divorces; Left with the property & other assets; Total net worth: \$164,402**



- **Divorce proceedings generate substantial legal fees for Mortensen**
- **Mortensen has difficulty finding work; Income dips significantly**

Facts of Mortensen



Year	Income	Year	Income
1994	\$54,000	2000	\$32,822
1995	\$57,000	2001	\$16,985
1996	\$46,500	2002	\$3,236
1997	\$62,690	2003	\$16,985
1998	\$53,360 - \$ 69,000	2004	About \$17,000
1999	Not in evidence	2005	Not in evidence

Also Note:

2001 – Cashed out an annuity for \$102,023.18

2005 – Created the trust



Facts of Mortensen

2004

- Mortensen sues wife for unpaid reimbursement and child support issues

- Mortensen states to an Alaska court:

“Saddled with debt and with increasing competition in my shrinking business market I have not recovered from the financial carnage of the divorce”

See: Bankruptcy Court Opinion – Footnote 8

Facts of Mortensen

2005

- February 2nd - Mortensen registers an Alaska Asset Protection Trust (AAPT)

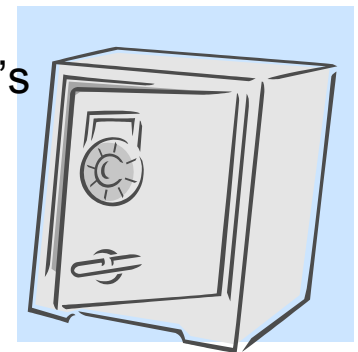
The express purpose of the trust was "to maximize the protection of the trust estate or estates from creditors' claims of the Grantor or any beneficiary and to minimize all wealth transfer taxes."

- February 3rd - Mortensen transfers the property, worth \$60,000, to the trust

- February 22nd & April 8th (two installments) - Mortensen's mother gives Mortensen \$100,000 "... to pay you for the Seldovia property that you have put into the trust"



Real Property



DAPT



Facts of Mortensen

Alaska Law required Mortensen to sign an affidavit representing:

- 1) he was the owner of the property being placed into the trust,
- 2) **he was financially solvent,**
- 3) **he had no intent to defraud creditors by creating the trust,**
- 4) no court actions or administrative proceedings were pending or threatened against him,
- 5) he was not required to pay child support and was not in default on any child support obligation,
- 6) **he was not contemplating filing for bankruptcy relief,** and
- 7) the trust property was not derived from unlawful activities.



Facts of Mortensen

Mortensen's February 2005
Balance Sheet

– By his own admission

Without Mom's gift and without the
transferred property:

- Assets: \$53,020
- Liabilities: (\$ 49,711)

With Mom's gift and without the
transferred property:

- Assets: \$153,020
- Liabilities: (\$ 49,711)

Facts of Mortensen

- Mortensen lends his mother's \$100,000 gift to the trust; Uses it contrary to the stated purpose of the trust which was to preserve the real property:
 - Speculates in the stock market; trust reports gains of \$39,000 between 2005 & 2007
 - Makes a car loan to an acquaintance
- Credit card debt increases rapidly
 - 02/05 → 12/06: + \$29,000



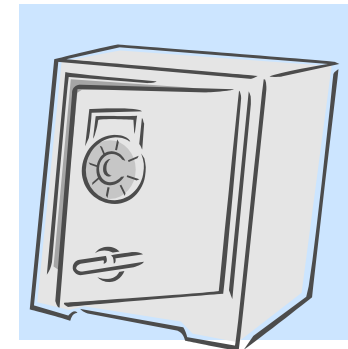
Facts of Mortensen



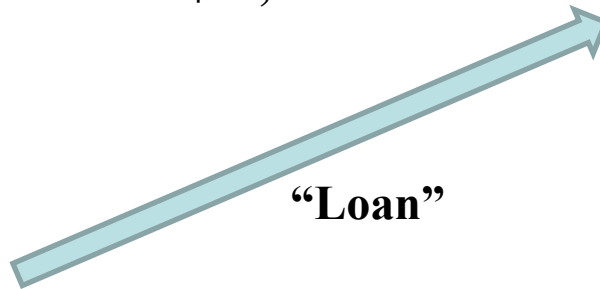
**Mortensen's
Real Property**



\$60,000 Gift



DAPT



"Loan"

Mortensen



\$100,000 Gift

**Mortensen's
Mother**

Mother: "Enclosed is my check ... to pay you for the Seldovia property that you have put into the trust for my three special 'Grands'!"

Facts of Mortensen

2009

- **Mortensen requires surgery & hospitalization**
- **Mortensen nearly \$250,000 in credit card debt**
- **Mortensen files for Chapter 7 Bankruptcy**
- **Bankruptcy trustee seeks the real property transferred to the trust**





Analysis of Section 548(e)(1)

•In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—

- such transfer was made to a self-settled trust or similar device
- such transfer was by the debtor;
- the debtor is a beneficiary of such trust or similar device; and
- the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

•The heart of the issue is that (D) requires “ actual intent to hinder, delay, or defraud.” If Congress wanted a strict ten year test it would never have added that portion of the statute.



What Does Mortensen Mean for DAPTs?

- Does the Mortensen case means that DAPTs don't work?
 - 10-year bankruptcy clawback
 - State statute of limitations for DAPTs
- Mortensen shouldn't have voluntarily gone through bankruptcy!!!
 - What was he thinking?
 - Involuntary bankruptcy: Very unlikely
 - Fraudulent conveyance: Quite possibly, but at least he would have had a chance



Avoiding Bankruptcy

- **DO NOT FILE** Voluntary bankruptcy
- Involuntary bankruptcy – overview of the general rules
 - If there are fewer than 12 creditors, a single creditor holding at least \$10,000 in unsecured debt may commence proceedings
 - If there are 12 or more creditors, 3 must join to commence proceedings
 - Creditors joining together is seen as unlikely, so those seeking to avoid involuntary bankruptcy have more than 12 creditors
 - Courts are split on whether small, reoccurring bills such as unpaid utilities count in determining the number of creditors
 - Creditors can be charged with the legal fees of the debtor if the claim is unsuccessful – discourages small creditors from filing



Involuntary Bankruptcy

- “Special circumstances” exception for involuntary bankruptcy
- Doesn’t require three creditors
- In re Smith, 437 B.R. 817 (Bkrpt.N.D.Tex., Oct. 12, 2010)
 - Egregious facts
 - Set up and funded self-settled Cook Islands asset protection trust three days before judgment rendered
 - Case stands for proposition that it is extremely difficult to force person into involuntary bankruptcy with less than three creditors joining in without egregious facts




Bad facts of Mortensen

- Actual trust language – “maximize the protection ... from creditors' claims”
- Weak balance sheet – at the time of trust formation after the property transfer and without Mom’s gift Mortenson’s net worth was only \$3,309
- Very weak recent income history:
 - 1994-1998 Average Income: \$56,274
 - 2000-2004 Average Income: \$17,415
- Massive credit card debt incurred after AAPT formed
 - 2005: \$49,711 in credit card debt
 - 2009: \$251,309 in credit card debt

Was this a Fraudulent Conveyance?



- 1. A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:
 - (a) With actual intent to hinder, delay or defraud any creditor of the debtor [4-yr. SOL/1-yr. tolling]; or
 - (b) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor [4-yr. SOL]:
 - (1) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
 - (2) Intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond his or her ability to pay as they became due.



Was this a Fraudulent Conveyance? [continued]

- 2. In determining actual intent under paragraph (a) of subsection 1, consideration may be given, among other factors, to whether:
 - (a) The transfer or obligation was to an insider;
 - (b) The debtor retained possession or control of the property transferred after the transfer;
 - (c) The transfer or obligation was disclosed or concealed;
 - (d) Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
 - (e) The transfer was of substantially all the debtor's assets;
 - (f) The debtor absconded;
 - (g) The debtor removed or concealed assets;
 - (h) The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
 - (i) The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
 - (j) The transfer occurred shortly before or shortly after a substantial debt was incurred; and
 - (k) The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.



3rd Party Trusts

548(e) does not apply to third party trusts


In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if--

- (A) such transfer was made to a **self-settled trust or similar device**
- (B) such **transfer was by the debtor**;
- (C) the **debtor is a beneficiary** of such trust or similar device;
and
- (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.



Do DAPTs Work after Mortensen?

- Remember that Mortensen was a bankruptcy claw-back case
 - This is nearly meaningless for our DAPT clients
 - Mortensen wasn't a good candidate for a DAPT
- After approximately 15 years since the first DAPT statute was enacted, not one of these cases has ever been tested through the court system
 - Excluding Mortensen which was a bankruptcy case and therefore wasn't an actual test with a non-bankruptcy situation
 - Theoretically, DAPTs have been working (i.e., causing settlements and avoiding lawsuits) because the vast majority believe they work and therefore people don't want to test them in court



Income Tax & Transfer Tax Status

- Income Tax
 - Grantor trust status – §§677(a)(1), (2)
- Gift Tax
 - Complete or incomplete gift?
 - CCA 201208026
- Estate Tax
 - Most of the time structured for pure asset protection & included in the taxable estate
 - Alternatively can be structured as a completed gift, likely excluded from the taxable estate
 - Application of IRC § 2036 ?



Completed Gift Issue

- **CCA 201208026**
- Donors gifted property to a trust and designated their adult child as the sole trustee.
- The Trust beneficiaries are the Donors' children, other lineal descendants, and their spouses. Trust terminates when both Donors have died.
- Trust is irrevocable, and that the Donors renounce any power to determine or control the beneficial enjoyment of Trust income or principal.
- Trust provides the Donors with testamentary limited powers of appointment.
- The trustee has absolute and unreviewable discretion in administering the Trust for the benefit of the beneficiaries. Income and principal may be distributed at any time for a beneficiary's health, education, maintenance, support, wedding costs, purchase of a primary residence or business, or for any other purpose. Income and principal may also be distributed to a charitable organization.



Completed Gift

- ***CCA 201208026, cont.***
- Issue 1 – the gift to the trust was a completed gift despite donors retained LPOA
 - Donors fully divested themselves of dominion and control of the property when they transferred the property to the Trust.
 - During the period extending from the creation of the Trust until the Donors' deaths, the trustee has sole and unquestionable discretion to distribute income and principal to the beneficial term interests. He may even terminate the Trust by distributing all of the property.
 - Needed to Retain “Veto” Power



PLRs 201310002 – 201310006

- A Nevada incomplete gift non-grantor trust (NING), using a lifetime special power of appointment with a HEMS standard.
- The IRS ruled that the trusts were non-grantor trusts for income tax purposes and that the transfers were incomplete for gift tax purposes.
- The IRS ruled that the distribution committee members do not have a general power of appointment.



You Have to Do “Something”

- Ironically, the small minority who question whether DAPT's work end up doing “nothing” to protect their clients' assets
 - Remember that you must do “something”
- The idea is to put enough walls around your clients' assets to frustrate and intimidate a potential future creditor into settling at a favorable dollar amount
- You should be talking to your clients about asset protection planning

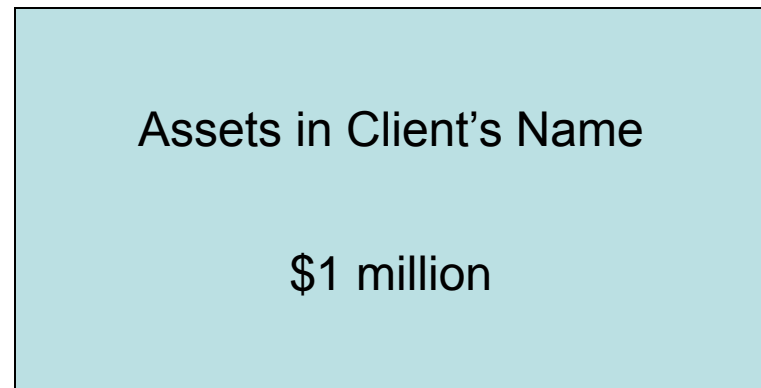
Nevada Asset Protection Trust with No LLCs: Example - \$2 million



Protected in two years ←



Not protected at all →



Here Comes the Creditor!!!

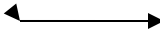


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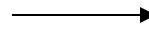
Nevada Asset Protection Trust with No LLCs: Example - \$2 million



Protected in two years



First two years: \$2 million lost



After two years: \$1 million lost



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Nevada Asset Protection Trust with One LLC: Example - \$2 million



Immediate charging order protection



Nevada Asset Protection Trust

Not protected at all



Nevada LLC

Client = 1%
NAPT = 99%

\$1 million

Assets in Client's Name

\$1 million

Here Comes the Creditor!!!



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Nevada Asset Protection Trust with One LLC: Example - \$2 million



Immediate charging order protection

Nevada Asset Protection Trust

\$1 million lost

Nevada LLC

Client = 1%
NAPT = 99%

\$1 million



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Nevada Asset Protection Trust with Two LLCs: Example - \$2 million



“Rainy Day” LLC

Nevada Asset Protection Trust

“Live Out Of” LLC

Nevada LLC #1

Client = 1% voting
NAPT = 99% non-voting

\$1 million

Nevada LLC #2

Client = 1% voting / 98% non-voting
LLC #1 = 1% non-voting

\$1 million

Here Comes the Creditor!!!



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Nevada Asset Protection Trust with Two LLCs: Example - \$2 million



“Rainy Day” LLC

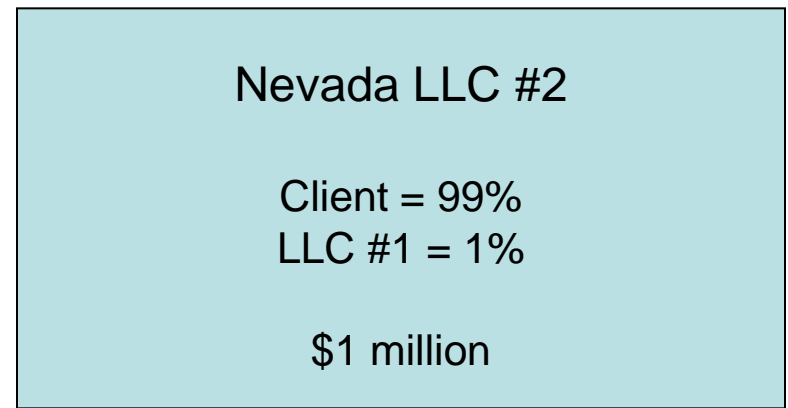


Creditor
1% charging order (lien)

NAPT
99%

TURN SPIGOT ON
“RAINY DAY” LLC

“Live Out Of” LLC



Creditor
99% charging order (lien)

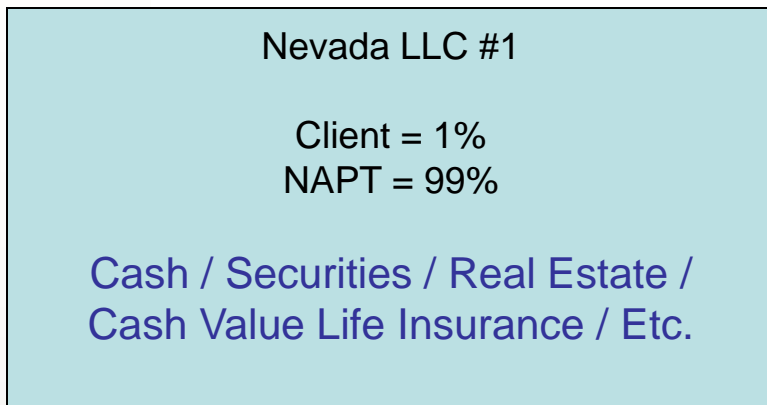
LLC #1
1%

TURN SPIGOT OFF
“LIVE OUT OF” LLC

Nevada Asset Protection Trust with Two LLCs



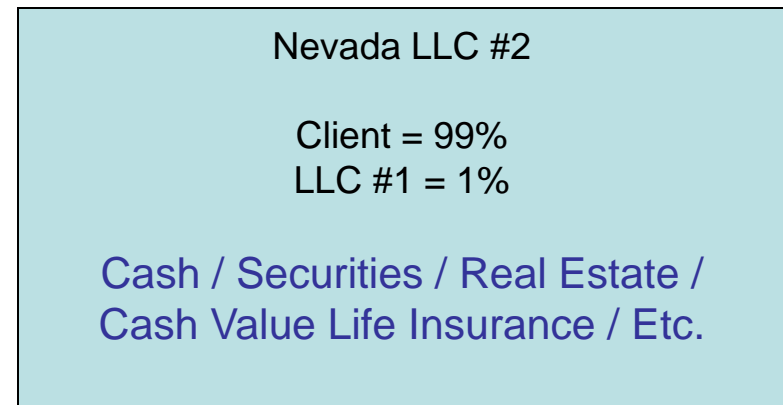
“Rainy Day” LLC



Creditor
1% charging order (lien)

NAPT
99%

“Live Out Of” LLC



Creditor
99% charging order (lien)

LLC #1
1%



DAPT State Rankings

- For chart, please visit:
http://www.oshins.com/images/DAPT_Rankings.pdf