DANIEL R. SCHRAMM, L.L.C.
Attorney at Law
121 Chesterfield Business Parkway
Chesterfield, Missouri 63005
Phone: (636) 532-2300
Fax: (636) 532-6002
Email: daniel@dschrammlaw.com
Web site: www.dschrammlaw.com

ASSET PROTECTION TECHNIQUES FOR INDIVIDUALS AND SMALL BUSINESSES

I originally prepared this asset protection article for a presentation to a group of individual investors. I then updated the article several times over the years for presentations to my business-networking group. The target audience for the article thus includes both individuals and small businesses.

My general topic is "asset protection." This term is often thrown around as an important feature in any program for estate planning or business succession. My goal with this article is to provide a simple primer on a few basic asset protection techniques. But as I thought more about the topic, it occurred to me that many people do not fully comprehend what the term "asset protection" means. So, the first question to ask is – "Protection from what?"

I came up with this short list of common threats that worry people when they think about protecting their personal or business assets. This list is by no means meant to be exhaustive. But common threats are:

- Lawsuits by third parties;
- Creditor claims against you or members of your family;
- Lawsuits and creditor claims against your business;
- Protecting the value of your business upon death;
- Wasteful spending or gambling by members of your family;

- Divorce;
- Retirement;
- Disability;
- Potential new spouse after your death;
- Spouses of your children;
- Long-term care issues;
- Federal and State income taxes;
- Federal estate taxes; and
- State inheritance taxes (if applicable in your State).

Federal Estate Tax Rules

For those of you who have accumulated or inherited significant wealth, one of your greatest asset protection concerns is undoubtedly the Federal Estate and Gift Tax. Congress has created a moving target for Federal estate taxes going at least as far back as 2001. Here is a brief summary of this recent history:

Under the The Economic Growth and Tax Relief Reconciliation Act of 2001, Congress gradually increased estate tax exemption amounts through 2009. Congress allowed the exemption amount to grow during the decade from $675,000 up to $3,500,000 in 2009. The top rates during this same period dropped from 55% to 45%.

Just before the end of the decade, Congress prevented the exemption amount from crashing down to $1 million by passing what was commonly called the 2010 Tax Relief Act. Through the end of 2012, Congress temporarily increased the estate tax exemption amount to just over $5,000,000 for individuals and to just over $10,000,000 for couples. The top estate tax rate was temporarily reduced to 35%.

On January 1, 2013, Congress passed The American Taxpayer Relief Act of 2012. This was the eleventh-hour tax deal designed to avert the infamous "fiscal cliff." Congress locked in the exemption amounts and rates in effect at that time, adjusted annually for inflation. So, for 2017, the exemption amount for individuals was $5,490,000 and $10,980,000 for couples.

Last December, President Trump signed into law the most recent tax reductions passed by Congress. People will argue about whether it was a good idea. The greatest reductions probably were for the corporate tax rates. But the law also had a significant effect on federal estate and gift taxes. For 2018, the exemption amount for individuals rose dramatically to $11,180,000 for individuals, and up to twice that amount, or $22,260,000 for couples. The top rate is now 40%. For 2018, the annual exemption amount for gifts increased to $15,000 per individual donee. Spouses can effectively double this annual amount by allocating half the gift to each spouse.

For the great majority of you whose gross estates will not ever approach the current federal estate tax exemption amounts, you should be relieved from having to consider complex estate tax planning strategies. The rest of you should have greater assurance of the rules going forward.

Use of Trusts for Asset Protection Purposes

Financial advisors, lawyers and tax advisors often recommend that their clients create trusts, in part, as a technique to protect assets. The trust may be created for more than one purpose. The most common purposes for creating a trust are (1) for estate tax planning; (2) to avoid probate; and (3) for general asset protection purposes. The relative importance of these purposes will vary depending upon the particular circumstances and needs of the person creating the trust. The person who creates the trust is commonly known as the Grantor.

The creation of a trust is not necessarily a panacea for all asset protection needs. Some issues, like concerns over disability or long-term care, may be best served with an insurance policy. Other issues, like the possible dissipation of assets from a divorce, can be covered with a carefully crafted ante-nuptial or post-nuptial agreement. A person can plan for retirement with a variety of pensions, annuities or qualified deferred income

tax investment accounts. An investment vehicle of this type often is protected by law from creditor claims.

This article is not designed to suggest that you create any particular type of trust. Nor do I intend to provide any estate planning or tax advice for your particular situation. I simply wish to outline some of the typical types of trusts that may be created, depending upon your particular needs. You are encouraged to consult with your lawyer before proceeding with a trust. I do not recommend that you cut costs by downloading a trust form from an online service and then trying to do it yourself. Because of the complexity of trust and tax law, I strongly advise against the use such forms without seeking advice from a qualified professional.

Here are some examples of different types of trusts:

- Testamentary Trust: This is a trust that is created in a will. The trust will not go into effect until after the death of the person who made the will.

- Intervivos Trust: This is a trust created by the Grantor when he or she is still living. The trust typically goes into effect at the time it is created.

- Revocable Trust: This is an intervivos trust that can be revoked or amended by the Grantor at any time while he or she is still living.

- Joint Husband/Wife Revocable Trust: This is a joint trust created by a husband and wife that may be revoked or amended by the spouses while they are still living, and depending upon how the trust is drafted, it also may be revoked or amended by the surviving spouse prior to his or her death. This type of trust is often used as an instrument for avoiding probate.

- Separate Husband/Wife Revocable Trusts: This is a more complex set of separate husband and wife trusts that may be revoked or amended by the creator of the particular trust. Two common purposes for creating separate husband and wife trusts are (1) to avoid probate; and (2) to minimize or avoid estate taxes.

- Missouri Qualified Spousal Trust (QST): This is a new form of joint husband and wife revocable trust recognized under Missouri law that provides the same creditor protection as a married couple ordinarily would enjoy if their jointly held property is held as tenants by the entirety. The Missouri statute permitting the QSTs went into effect in 2011. The law permits QSTs to be divided into separate sub-trusts for estate tax planning purposes.

- Irrevocable Trust: This is a trust that cannot be revoked by the Grantor once it is created. This kind of trust is often coupled with life insurance for estate tax planning purposes. An irrevocable trust for life insurance is commonly called an irrevocable life insurance trust, or ILIT.

Generally speaking, your trust should contain what is called a "spendthrift clause" for asset protection purposes. The following is a sample of such a clause:

> "The interest of any beneficiary in the principal or income of any trust estate shall not be subject to the claims of any creditor nor be voluntarily transferred, assigned, encumbered or otherwise disposed of, except by the exercise of a power of appointment or right of withdrawal specifically granted herein."

What does that mean? In simple terms, this clause provides that the assets belong to the trust and not the beneficiary. Because the trust share is not the beneficiary's property, the beneficiary has no power to give it up or borrow against it, and creditors must keep their hands off. Bear in mind, though, that this kind of clause ordinarily will not protect the original Grantor of a revocable trust from creditor claims. The reason is that the Grantor of such a trust retains control over the trust assets.

When you create a Grantor trust, you often face an important question: Do you want to distribute trust shares to your children upon reaching a certain age, or maintain the shares in trust throughout their lives? By making a distribution, you need to understand that the asset protection value of trust will be lost. The size of the trust estate may be an important consideration in evaluating this question.

Asset Protection Techniques for Small Businesses

When you form your business, you want to do so in a way that will provide limited liability protection. Why? To the extent possible, you want to try to keep your personal assets from being exposed to business lawsuits and creditor claims. Examples of small business entities with limited liability protection are:

- Subchapter S corporations;
- limited liability companies, or LLCs;
- limited liability partnerships, or LLPs;
- limited partnerships, or LPs; and
- professional corporations, or PCs;

You must comply with different legal formalities for each of these business entities. You should consult with your tax advisor to determine the form of ownership that makes the most sense for your business. Examples of more dangerous small business entities with NO limited liability protection are general partnerships and sole proprietorships. I advise against these disfavored forms of ownership. Regardless of what form of ownership you use, you will want to have adequate business insurance to protect you from losses caused by catastrophic events and liability issues.

As a practical matter, you may be forced to expose at least some of your personal assets to liability if you own a small business with minimal credit and no significant earnings history. Landlords and lending institutions may insist on personal guarantees from the owners of such a business. Depending on the circumstances, you may be able to avoid unlimited exposure by negotiating limitations in the terms of the personal guaranty.

Any business owner needs to think through questions of business succession planning. A common way to handle such issues is to create a so-called “buy-sell agreement.” There are many variations in such agreements depending on the particular circumstances and tax consequences. The agreement is often coupled with key person life insurance or disability

insurance to ensure that sufficient money if available to pay any purchase price under the buy-sell provisions.

If you don't have a buy/sell agreement, you at least want to have some kind of transfer on death agreement with the company to transfer your business ownership interest effective upon death. A common way to handle this problem is to transfer your business ownership interest upon death to a trust. But be careful. The trust may be restricted from serving as the business owner by law or professional licensing rules. So, for example, a trust may not serve as a shareholder of a subchapter S corporation unless it satisfies the rules for qualified subchapter S trusts. See, 26 U.S.C. §1361(b)(1)(D). Your trust ordinarily should have provisions to create a qualified sub-trust for this purpose. And you may be prevented by professional licensing rules from naming your trust as the owner of, say, a law firm or an accounting practice.

If these kinds of restrictions do not apply, you may want to make your trust the owner of the business interest when you're still alive. This also will avoid having a probate issue for your business upon death. But this approach could be problematic if you and your spouse have a joint trust and the spouse doesn't want to be part of the business. Under those circumstances the transfer on death agreement may make more sense.

Business succession techniques of this nature are complicated and should not be undertaken without proper advice from your lawyer.

Conclusion

This summary shows that the term "asset protection" can mean different things to individuals and small business owners. I have not written this article to provide a comprehensive analysis of all possible asset protection techniques. Instead, I have just defined a few basis terms and brought up some potential ideas. Hopefully, this will help you to speak intelligently with your lawyer about how different techniques may apply in your situation.

DISCLAIMERS: This article contains general information for discussion purposes only. The author is not rendering legal advice, and this article does not create an attorney-client relationship. Each case is different and must be judged on its own merits. Missouri rules generally prohibit lawyers from advertising that they specialize in particular areas of the law. This article should not be construed to suggest such specialization. The choice of a lawyer is an important decision and should not be based solely upon advertisements.

IRS Circular 230 Disclosure Notice. If this communication is made as part of an e-mail communication or attachment and contains any tax advice, such advice in not intended or written to be used, and it cannot be used, for the purpose of avoiding tax penalties that may be imposed on a taxpayer. Furthermore, if this communication contains any tax advice, such advice may not be used or referred to in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement, and a taxpayer receiving such information under such circumstances should advice from an independent tax advisor.

©Daniel R. Schramm, L.L.C. (2018)