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## Overview of Asset Protection

### A. What is Asset Protection?

For the past several years asset protection has been one of the fastest growing areas of law. It is also one of the most controversial – the goal of asset protection is to shield assets from the reach of creditors.

Asset protection should simply be about structuring the ownership of one's assets to safeguard them from potential future risks. Most asset protection structures are commonly used business and estate planning tools, such as limited liability companies, family limited partnerships, trusts and the like. Properly implemented asset protection planning should be legal and ethical. It should not be based on hiding assets or on secrecy. It is not a means or an excuse to avoid or evade U. S. taxes.

There is no one "magic bullet" in asset protection. The term "asset protection" encompasses a number of planning and structuring mechanisms that may be implemented by a practitioner to minimize a client's exposure to risk. For each client the asset protection solution will be different, depending on (i) the identity of the debtor; (ii) the nature of the claim; (iii) the identity of the creditor; and (iv) the nature of the assets. These are four threshold factors that are either expressly or implicitly analyzed in each asset protection case. The analysis of these four factors determines what planning would be possible and effective for a specific client.

### B. Identity of the Debtor

In analyzing the identity of the debtor, practitioner should consider the following initial issues:

1. Is the debtor an individual or an entity?
  - a. If the debtor is an individual:
    - i. Does he or she have a spouse, and is the spouse also liable? For example, the spouse may be liable as a co-signor of a personal guarantee or as a co-owner of community property assets.
      - A. If the spouse of the debtor is not liable, is it possible to enter into a transmutation agreement transmuting the assets from community property to the respective separate property of each of the spouses?<sup>1</sup>
    - ii. Are the spouses engaged in activities that are equally likely to result in lawsuits, or is one spouse more likely to be sued than the other?
  - b. If the debtor is an entity:
    - i. Did an individual guarantee the entity's debt?
    - ii. How likely is it that the creditor will be able to pierce the corporate veil, or otherwise get at the assets of the individual owners?

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<sup>1</sup> See California Family Code ("CFC") Section 850 for rules governing transmutation agreements and the discussion below (Section IV, Planning in the Context of Marriage).

iii. Is there a statute that renders the individual personally liable for the obligations of the entity? For example, Section 6672 of the Internal Revenue Code of 1986, as amended (the "Code") renders those persons who are "responsible persons" liable for federal withholding taxes that were withheld but unpaid to the IRS.

Often, clients assume that if assets are placed within a limited liability entity, such assets are shielded from lawsuits. Another common assumption is that a lawsuit against such an entity cannot reach the owners of the entity. These assumptions are frequently erroneous (see Section VIII, Choice of Entity).

### **C. The Nature of the Claim**

It is not sufficient to know the identity of the debtor. The practitioner will also need to know what type of a claim will be brought against the client. Here are some variables:

1. Are there any specific claims against the client, or is asset protection being undertaken as a result of a general fear of lawsuits and the desire to insulate the client from lawsuits?

2. Has the claim been reduced to a judgment? If the claim has been reduced to a judgment, what assets does the judgment encumber? For example, a lien will cover only those assets that are titled in the name of the defendant. If there is any variance, the judgment lien will not attach. Similarly, a notice for a debtor's examination will impose an automatic lien only on those assets which are titled in the name of the debtor.<sup>2</sup>

3. Has the claim matured to the extent that any transfer of assets will constitute a fraudulent transfer?

4. Is the claim brought against the debtor a tort claim? Tort claims are generally covered by liability insurance. To the extent that asset protection is desired, it is because the plaintiff will deem that the insurance coverage is not sufficient, and will seek to get the defendant to contribute to a settlement with the defendant's own funds.

5. Certain debts are subject to pre-judgment attachment, if: (i) they arose in the context of the debtor's business, and (ii) the amount owed is readily ascertainable. In this case the plaintiff does not need to wait until he obtains a judgment in order to encumber the asset. However, the amount of the debt must be evident from the face of the instrument sued upon, such as a promissory note or a liquidated damage provision.<sup>3</sup>

6. An always relevant question is the dischargeability of the claim in bankruptcy. If the claim is dischargeable in bankruptcy, and the debtor's debts are exempt or otherwise unreachable, then asset protection planning may not be warranted - a bankruptcy discharging the claim will be sufficient.

a. The fact that a claim is dischargeable provides leverage when negotiating with creditors.

b. Asset protection planning and bankruptcy planning usually go hand-in-hand. Often the goal of asset protection planning is to structure the debtor's assets so that upon the filing of a bankruptcy the debtor's claims are discharged and assets are retained.

<sup>2</sup> See, California Code of Civil Procedure ("CCP") Section 697.910(a).

<sup>3</sup> See, CCP Section 484.010(c) NOTE: Courts construe this statute strictly. The creditor must show that the debt arose out of the exact business that the debtor was engaged in. See, Nakasone v. Randall (1982) 129 Cal. App. 3d 757, 181 Cal. Rptr. 324.

c. Certain debts, such as debts occasioned by fraud or breach of fiduciary duty, are not dischargeable in a Chapter 7 bankruptcy.<sup>4</sup> However, if the debtor qualifies under Chapter 13, even fraud claims may be effectively eliminated.

d. Federal income taxes are generally dischargeable in bankruptcy, provided that:<sup>5</sup>

- i. The tax is assessable;
- ii. The tax has been assessed or has been assessable for more than 240 days; and
- iii. More than three years have elapsed from the due date of a timely filed return, or more than two years from the date of a late filed return, whichever is later.<sup>6</sup>

e. California income taxes are dischargeable four years from the due date of the return. However, if the California tax arises out of a federal income tax liability, the California tax is not dischargeable until four years from the date of filing of the amended return reporting the tax that arose from the federal liability.

f. Federal and state employment tax liabilities are generally not dischargeable.

g. It is unclear whether sales tax liabilities are dischargeable.

7. What is the statute of limitations for bringing the claim?

a. The IRS may not assess any income tax after 3 years from the filing of the return.<sup>7</sup>

- i. Exceptions: Fraud or unfiled return: no statute of limitations.<sup>8</sup>
- ii. Where gross receipts (not income tax) is underreported by more than 25% of the amount required to be stated on the return: six year statute.<sup>9</sup>

b. The IRS has 10 years to collect any assessed tax. If the IRS cannot collect the tax within 10 years of assessment, the tax lien is removed and the tax debt extinguished.<sup>10</sup> This is also true of assessments resulting from unpaid employment taxes.

c. There is no statute of limitations with respect to the collection of assessed California income or employment taxes.

8. What is the size of the potential claim? Creditors become more aggressive if the liability is greater. In addition, certain asset protection strategies are more expensive than others.

<sup>4</sup> See, 11 U.S.C. Section 523.

<sup>5</sup> NOTE: This results only in the IRS losing its preference in bankruptcy. If the debtor has sufficient assets such that any unsecured creditor could recover in bankruptcy, the IRS will recover as well.

<sup>6</sup> See 11 U.S.C. Section 507.

<sup>7</sup> Code Section 6501(a).

<sup>8</sup> Code Sections 6501(c)(1) and (3).

<sup>9</sup> Code Section 6501(e)(1).

<sup>10</sup> See Code Section 6502(a)(1).

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## ***D. Identity of the Creditor***

The third factor to be considered before implementing an asset protection strategy is the identity of the creditor. Here we are referring to certain creditor traits:

1. How aggressive/lazy is the creditor? How smart/knowledgeable is the creditor and the creditor's counsel? Accurately answering these questions will help us determine the scope of collection activities that the creditor is likely to engage in. This tells us how much protection the debtor requires.
2. Is the creditor a government agency? Taxing authority? Some government agencies possess powers of seizure that other government agencies do not. For example, the Federal Trade Commission has the power to seize assets that it deems are used to defraud creditors.
  - a. The IRS is now prevented from levying upon any asset without first giving the taxpayer the right to a Collection Due Process hearing to determine whether the proposed seizure is proper and is not an abuse of discretion.<sup>11</sup>
  - b. There is no such prohibition on the ability of the California Franchise Tax Board to seize assets, but as a matter of policy the FTB will not seize a taxpayer's residence to pay a tax debt.
3. Is the potential creditor a spouse in a divorce that has not yet been filed? When a dissolution proceeding is commenced in California, an automatic freeze goes into effect, *i.e.* once the petition is filed, neither party to the proceeding has the right to transfer assets other than in the normal course of the marriage.

## ***E. The Nature of the Assets***

The final factor that needs to be analyzed is the nature of the assets we are seeking to protect. This factor, to a much greater extent than anything else, will determine what may be done and what needs to be done to protect the debtor:

1. To what extent are the assets exempt from the claims of creditors?
  - a. The California Homestead Exemption (\$75,000, \$100,000 or \$175,000 depending on the circumstances).<sup>12</sup>
  - b. Assets in a qualified plan, *i.e.* assets in a plan under the Employee Retirement Income Security Act of 1974 ("ERISA") are generally exempt from the claims of creditors.<sup>13</sup>
    - i. A statutory exception exists for divisions of property incident to a divorce. A spouse may obtain a Qualified Domestic Relations Order ("QDRO") which has the effect of requiring the trustee of the plan to disgorge assets to the other spouse pursuant to the order. The spouse may also reach the assets of the qualified plan to satisfy an alimony obligation or child support.
    - ii. Assets in a qualified plan that are maintained solely for "employee-owners," *i.e.* plans whose only participants are owners, do not qualify for the exemption.

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<sup>11</sup> See Code Section 6330.

<sup>12</sup> See CCP Sections 704.720 and 704.730 and discussion below.

<sup>13</sup> See, Patterson v. Shumate, 112 S. Ct. 2242 (1992).

iii. The Internal Revenue Service may generally reach the assets of a qualified retirement plan. In U. S. v. Sawaf, 74 F. 3d 119 (1996), the court held that the Service can enforce its judgment by garnishment against the taxpayer's ERISA-qualified plan.

c. Assets in a non-qualified plan (called "private retirement plans" under California law) are exempt from the claims of creditors; and assets in an IRA or any other self-employed retirement plan are exempt to the extent the assets are necessary for the retirement needs of the debtor and the debtor's dependents.<sup>14</sup>

d. Face amount of life insurance and annuity policies is protected without a limitation, but loan values are protected only up to \$9,700.<sup>15</sup>

e. Certain small exemptions are listed in the Code of Civil Procedure. This includes household furnishings, appliances and clothing (exempt without a limitation but to the extent ordinarily and reasonably necessary to the debtor),<sup>16</sup> jewelry, heirlooms and art (up to \$6,075),<sup>17</sup> and tools of the trade (up to \$6,075).<sup>18</sup>

2. How are the assets titled? If assets constitute community property, it is usually irrelevant that the assets are titled in the name of one spouse. The creditor can attach all of the community property, even if only one spouse is the debtor. This may hold true even if the debt arose prior to the marriage.<sup>19</sup>

3. The ability of a creditor to foreclose upon the assets of a trust of which the debtor is a beneficiary is governed by the Probate Code. As a general rule, a creditor has no right to attach the assets of a trust that is a spendthrift trust (but see discussion below).<sup>20</sup>

a. Also as a general rule, if a beneficiary has no right to receive assets from a trust (*i.e.* where the trustee has the discretion to withhold distributions or where the trustee has a limited power of appointment to choose among different beneficiaries) the beneficiary's creditors will have no greater rights to the trust's assets than the beneficiary does.

b. A settlor in California cannot avoid his or her own creditors by placing the assets in a self-settled trust.<sup>21</sup> This rule does not obtain in many foreign jurisdictions that seek to attract trust assets, and has been repealed in Alaska, Delaware, Nevada and Rhode Island.

<sup>14</sup> See CCP Section 704.115. "...exempt only to the extent necessary to provide for the support of the judgment debtor when the judgment debtor retires and for the support of the spouse and dependents of the judgment debtor, taking into account all resources that are likely to be available for the support of the judgment debtor when the judgment debtor retires."

<sup>15</sup> CCP Section 704.100.

<sup>16</sup> CCP Section 704.020(a).

<sup>17</sup> CCP Section 704.040.

<sup>18</sup> CCP Section 704.060(a).

<sup>19</sup> See CCP Sections 695.020, 703.020 and 703.110.

<sup>20</sup> California Probate Code ("Probate Code") Section 15300. "Except as provided in Sections 15304 to 15307, inclusive, if the trust instrument provides that a beneficiary's interest in trust income is not subject to voluntary or involuntary transfer, the beneficiary's interest in income under the trust may not be transferred and is not subject to enforcement of a money judgment until paid to the beneficiary."

<sup>21</sup> Probate Code 15304(a).

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Each of the issues presented above should be carefully considered by a practitioner before structuring and implementing an asset protection plan. The following discussion will address some specific issues present in asset protection in greater detail.