Trusts & Estates
NEWS

MURTHA CULLINA

EFFECTIVE ESTATE PLANNING FOR PHYSICIANS: TAX AND LIABILITY MITIGATION

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The Trusts & Estates Group at Murtha Cullina is pleased to provide clients and friends with information about topics of interest in the estate planning area.

If you have questions about the issues addressed in this newsletter, or any other matters involving estate planning issues, please feel free to contact any of the following attorneys:

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Estate planning for physicians has become more complex. On the one hand physicians want to make the maximum use of available federal and state estate tax exemptions and deductions. On the other hand, they are concerned about exposing assets to litigious patients. Last month, a jury awarded eight million dollars in a wrongful death lawsuit against a former Connecticut physician, and last year a plaintiff pursued a physician's personal assets for amounts over the available insurance coverage. Faced with stories like that, physicians often struggle to decide how best to satisfy competing concerns. Couple that with the legal and moral morass of fraudulent conveyances and the personal risk is significantly intensified. However, by maintaining the focus on effective estate planning, these problems can be mitigated because asset protection is an incidental benefit of estate planning.

Asset Ownership and Estate Planning. The typical estate plan for a physician and spouse will utilize the federal unified credit equivalent and the unlimited marital deduction for both spouses to eliminate and defer estate taxes. Depending on the available exemption and the size of the combined estate, the physician must own some portion of the assets. However, when faced with this advice, the reaction of the physician has become instinctive – "But what about my risk in the event of litigation?"

Liability Insurance. Liability insurance is a simple and effective way of mitigating the angst over litigation exposure while allowing the physician to retain ownership of assets and estate plan effectively. However, the protection is limited to the face amount of the policy. In the case above, the recovery exceeded the policy limits and the physician's personal assets were exposed.

Transfer Assets Out of Your Estate. After liability insurance, transferring all assets to a spouse or children is the most utilized defense. However, this approach can completely undermine effective estate planning. Further, joint ownership is not an effective compromise since one half of the value of the assets will be exposed to litigants and full use of credits will require additional "disclaimer" planning. Gifts to children have the added complexity of gift taxes and the loss of control of the assets.

Use of an Entity. Limited partnerships and limited liability companies can allow for retained ownership but make seizure by a creditor particularly unattractive. The physician would invest in the entity and receive a limited partnership interest or a non-voting membership interest. The physician's spouse or, if for an unmarried physician, an irrevocable trust would be the general partner or the voting member. The physician would own a valuable asset for estate planning purposes but has no control over the asset. A potential creditor through litigation could receive a "charging order" which would allow the creditor to step into the shoes of the physician. However, the lack of control, the inability to sell or liquidate the interest and the exposure for imputed income and the related tax liability without cash flow will either completely deter the creditor or, at the very least, lead to settlement leverage.

Use of Exempt Assets. Exempt assets, such as qualified retirement plans,

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including 401(k) and IRAs, provide varying degrees of protection from creditors if created prior to the existence of a claim. The Employee Retirement Income Security Act ("ERISA") and state laws are controlling and for purposes of Connecticut, 100% of the assets held in a 401(k) plan or an IRA are exempt from creditors. However, as with other exempt assets, once the assets are withdrawn, the money is no longer protected.

A particular qualified retirement plan that is becoming more popular with physician clients is the cash balance pension plan. With a cash balance pension plan qualified under ERISA, creditors cannot reach the plan due to the protection that ERISA provides. However, the limitations of a cash balance pension plan are that the practice must make contributions for all of the employees and depending on the practice's employee mix, this type of plan can be very expensive. The members of the practice will need to agree and the practice must have sufficient cash flow to fund the plan.

Use of Self-Settled Trusts. In conventional estate planning, a settlor is the grantor and beneficiary of a revocable trust. Creditors are able to invade revocable trusts because the settlor is a beneficiary and has retained access. If the settlor creates an irrevocable trust and is not a beneficiary, and assuming no fraudulent conveyance, the creditors will not have access to the assets in that trust. Self-settled trusts are irrevocable trusts where the settlor is the grantor and beneficiary but due to jurisdictional restrictions or state statutes that favor debtors, creditors cannot invade these trusts. Thus, these trusts are attractive for individuals wanting to retain access to assets but protect such assets from creditors. Self-settled trusts also can play a significant role in the estate plan.

Foreign or "offshore" self-settled trusts are useful because of specific jurisdictional laws that provide protection from creditors. However, offshore self-settled trusts are expensive to create and administer and there is still a large amount of uncertainty surrounding whether the trusts are effective. In addition, the conflict of U.S. and foreign laws poses a strong concern. Finally, foreign trusts have attracted the attention of the Internal Revenue Service.

Domestic self-settled trusts provide another alternative. This type of trust is the result of certain states enacting statutes which are more considerate of debtors than creditors. The most comprehensive statutes are found in Alaska, Delaware, Nevada and South Dakota. Each of these four states provide varying levels of protection from certain types of creditors (divorcing spouses, alimony, preexisting tort creditors, etc.). Similar to offshore self-settled trusts, these domestic trusts also have their drawbacks including the cost to establish and administer them and the need for the trustee and the situs of the trust to be in the state with the favorable laws. In addition, many of the state statutes incorporate a look-back period to restrict the ability of a person with knowledge of a claim to attempt to utilize the statute to defeat a creditor. Most importantly, the enforceability of domestic asset protection trusts are not as clear with settlors who reside outside of the situs state.

Fraudulent Conveyance. Preemptive action and a lack of intent to defeat creditors are key components of successful asset ownership planning because state and federal laws void fraudulent transfers, i.e., transfers of assets purposefully made to defeat the rights of creditors. Most states have laws that prohibit fraudulent conveyances and impose strict penalties on violators. A principal component in determining whether a transfer is fraudulent is whether or not a present or reasonably foreseeable creditor exists at the time of the asset transfer. A creditor is reasonably foreseeable when the transferor knew or should have known that a claim was likely to arise. Once a claim is likely, it is too late to transfer assets out of a creditor's reach.

Conclusion. Effective estate planning can minimize not only tax exposure but also the risk of recovery by litigating third parties. Further, focusing on estate planning can also alleviate the moral and legal dilemma of "asset protection." Undertaking planning sooner rather than later is important because death and taxes are a certainty and, for physicians, litigation claims are nearing that threshold.

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