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Asset Protection

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Introduction

If you haven't done any asset protection planning, your wealth is vulnerable to potential future creditors and, should the worst happen, you could lose everything.

Lawsuits, taxes, accidents, and other financial risks are facts of everyday life. And though you'd like to believe that you're safe, misfortune can befall even the most careful person. What can you do? First, identify your potential loss exposure, then implement strategies that are designed to help reduce that exposure without compromising your other estate and financial planning objectives.

First, a word about fraudulent transfers

Part of your overall asset protection plan might include repositioning assets to make it legally difficult for potential future creditors to reach them. This does not, however, extend to actions that hide assets or defraud creditors. If a court finds that your asset protection plans were made with the intent to defraud, it will disregard those plans and make the assets available to creditors.

How can you avoid running afoul of the fraudulent transfer laws?

- Make sure your plans are made for legitimate business purposes or to accomplish legitimate estate planning objectives
- Carefully document the legitimate business and estate planning purposes of any arrangements you make
- Put your plans into effect before you have any problems with creditors
- Do not implement a plan at a time when a lawsuit is imminent or pending or at a time when you have an outstanding debt that you believe you may be unable to pay

Where the dangers lie

Unexpected liability can come from just about anywhere:

- The IRS and other tax authorities
- Accident victims, including victims whose injuries were caused by the actions of minor children or employees
- Doctors, hospitals, nursing homes, and other health-care providers
- Credit card companies
- Business creditors, including employees and former employees, governmental agencies, suppliers, customers, partners, shareholders, and the general public
- Creditors of other individuals, where you have cosigned or guaranteed obligations for those individuals
- Marital or other live-in partners

Asset protection techniques

There are three basic asset protection techniques: insurance, statutory protection, and asset placement. None of these techniques is a complete solution by itself, but may make sense as one limited component of an asset protection plan.

Insurance

The simplest way to cope with risk is to shift the risk to an insurance company. This should be your first line of defense. Before you do anything else, review your existing coverage. Then consider purchasing or increasing coverage on your insurance policies as appropriate. You should be adequately insured against:

- Death and disability
- Medical risk, including long-term care

- Liability and property loss (both personal and business)
- Other business losses

Statutory protection

Creditors can't enforce a lien or judgment against property that is exempt under federal or state law. While exemption planning can't offer total protection, it can offer some shelter for certain assets.

Both federal and state laws govern whether property is exempt or nonexempt in nonbankruptcy proceedings (separate federal and state laws govern whether property is exempt or nonexempt in bankruptcy proceedings). Generally, you can choose whether the federal exemption or the state exemption applies. When looking at exemption laws, be sure to find out how much of an exemption is allowed for a particular type of property--it may be completely exempt, or exempt only up to a certain amount or restricted in some way. Types of property often receiving an exemption include:

- Homestead (principal residence)
- Personal property
- Motor vehicle
- IRAs, pension plans, and Keogh plans
- Prepaid college tuition plans
- Life insurance benefits and cash value
- Proceeds of life insurance
- Proceeds of annuities
- Wages

Tip: *In those jurisdictions that recognize ownership by* tenancy by the entirety (TBE) *, creditors of the husband or creditors of the wife cannot reach TBE assets.*

Asset placement

Asset placement refers to transferring legal ownership of assets to other persons or entities, such as corporations, limited partnerships, and trusts. The basis for this technique is simple--creditors can't reach property that you do not own or control.

Shifting assets to the spouse who is less exposed to claims

If you have high exposure to potential liability because of your occupation or business, it may be advisable for you to shift assets to your spouse. Your spouse would retain the assets that are subject to the exposure as his or her separate property, and you would retain assets that enjoy statutory protection, such as the homestead, life insurance, and annuities, as separate property. Furthermore, the shifting of assets to a spouse or children may help accomplish other estate planning goals.

Caution: *To avoid complications in the event that your marriage ends in divorce, both you and your spouse should agree to the division of assets in writing. This is especially important in* community property states *.*

C corporations

If you own a business and aren't already a C corporation , changing your business structure to a C corporation will make it a separate legal entity in the eyes of the law. As such, a C corporation owns the business assets and is responsible for all business debts. Thus, incorporating your business separates your business assets from your personal assets, so your personal assets will generally not be at risk for the acts of the business.

Caution: *The limited liability feature may be lost if, for example, the corporation acts in bad faith, fails to observe corporate formalities (e.g., organizational meetings), has its assets drained (e.g., unreasonably high salaries paid to shareholder-employees), is inadequately funded, or has its funds commingled with shareholders' funds.*

Caution: *A number of issues should be considered when selecting a form of business entity, including tax considerations. Consult an attorney and tax professional.*

Limited liability companies (LLCs) and partnerships (LLPs and FLPs)

An LLC is a hybrid of a general partnership and a C corporation. Like a partnership, income and tax liabilities pass through to the members, and the LLC is not double-taxed as a separate entity. And, like a C corporation, an LLC is considered a separate legal entity that can be used to own business assets and incur debt, protecting your personal assets from other nontax claims against the LLC.

Professionals (e.g., doctors, lawyers, and accountants) face liability for damages that result from the performance of their professional duties. While no business structure will protect you from personal liability for your professional activities, an LLP will protect you from the professional mistakes of your partners. That is, if one of your partners is sued, and the LLP is also named in the lawsuit, any malpractice judgment is the personal liability of the partner who's been sued, but a business liability for you and the other partners. Your personal assets aren't at stake if your partner commits malpractice, although your investment in the business may still be at risk.

An FLP is a limited liability partnership formed by family members only. At least one family member is a general partner; the others are limited partners. A creditor can't obtain a judgment against the FLP--it can only obtain a charging order. The charging order only allows the creditor to receive any income distributed by the general partner. It does not allow the creditor access to the assets of the FLP. Thus, a charging order is not an attractive remedy to most creditors. As a result, the limitation to seeking a charging order can often convince a creditor to settle on more reasonable terms than might otherwise be possible.

Protective trusts in general

A protective trust can protect both business and personal assets from most creditors' claims. A trust works because it splits ownership of trust assets; the trustee has equity ownership and the beneficiaries have beneficial ownership. Essentially, a protective trust works like this:

Example(s): *Harry would like to leave property to Wendy. However, Harry is afraid that his creditors might claim the property before he dies and that Wendy will receive none of it. Harry establishes a trust with both himself and Wendy as the beneficiaries. The trustee is instructed to allow Harry to receive income from the trust until Harry dies and then to distribute the remaining assets to Wendy. The trust assets are then safe from being claimed by Harry's creditors, so long as the debt was entered into after the trust's creation.*

Example(s): *Under these circumstances, any of Harry's creditors would be able to reach assets in the trust only to the extent of Harry's beneficial interest in the trust. Say that Harry's interest in the trust is a fixed income distribution each month in the amount of $1,000. Assuming Harry's creditors obtained a judgment, they would only be entitled to the $1,000 per month.*

Irrevocable trusts

As the name implies, an irrevocable trust is a trust that you can't revoke or change. Once you have established the trust, you can't dissolve the trust, change the beneficiaries, remove assets from the trust, or change its terms. In short, you lose control of the assets once they become part of the trust. But, because the assets are out of your control, they're generally beyond the reach of creditors too. You may further protect those assets from your beneficiaries' creditors by using special language (known as a spendthrift clause) in the trust.

Caution: *Unlike an irrevocable trust, a revocable trust provides the assets in the trust with absolutely no legal protection from your creditors.*

Offshore (foreign) trusts

It's possible to transfer assets to trusts that are formed in foreign countries (certain countries are preferred). While the laws of each country are different, they share one similarity--they make it more difficult for creditors to reach trust assets.

Here's how it works: In order for a creditor to be able to reach assets held in a trust, a court must have jurisdiction over the trustee or the trust assets. Where the trust is properly established in a foreign country, obtaining jurisdiction over the trustee in a U.S. court action will not be possible. Thus, a U.S. court will be unable to exert any of its powers over the offshore trustee.

So, the creditor must commence the suit in the offshore jurisdiction. The creditor can't use its U.S. attorney; it must use a local attorney. Typically, a local attorney will not take the case on a contingency fee basis. Therefore, if a creditor wants to pursue litigation in the offshore jurisdiction, it must be prepared to pay the foreign attorney up front. To make matters even less convenient, many jurisdictions require the creditor to post a bond or other surety to guarantee the payment of any costs that the court may impose against the creditor if it is unsuccessful. Taken as a whole, these obstacles have the general effect of deterring creditors from pursuing action.

Domestic self-settled trusts

The laws in Alaska, Delaware, Nevada, and a few other states enable you to set up a self-settled trust . Alaska was the first state to enact such an anti-creditor trust act, and Delaware quickly followed. Hence, this type of trust is often called an Alaska/Delaware trust (sometimes also referred to as a domestic asset protection trust, or DAPT). A self-settled trust is a trust in which the person who creates the trust (the grantor) can name himself or herself as the primary, or even sole, beneficiary. These trusts give the trustee wide latitude to pay as much or as little of the trust assets to any or all of the eligible beneficiaries as the trustee deems appropriate. The key to this type of protective trust is that the trustee has the discretion to distribute or not distribute the trust property. Creditors can only reach property that the beneficiary has the legal right to receive. Therefore, the trust property will not be considered the beneficiary's property, and any creditors of the beneficiary will be unable to reach it.

Caution: *Domestic self-settled trusts may not be as effective as a foreign trust, because a judgment from an individual state must be honored by another state under the United States Constitution.*

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