Asset Protection Strategies

Concept

The use of asset protection strategies has gained the attention of wealthy Americans over the years as the legal system has become increasingly subject to unwarranted litigation. As a result, creditor protection can play a significant role in planning for many individuals.

Situation

Asset protection is about protecting assets before the need arises; it is not about protecting assets from existing creditors. In other words, the implementation of asset protection strategies is appropriate in situations where an individual is concerned about the claims of future creditors.

Requirements and Logistics

While the strategies listed do not include all asset protection possibilities, the list below provides an overview of some of the types of available techniques.

Beware of Fraudulent Transfers

For asset protection to be effective, it is critical that there is no fraudulent transfer of assets. If a court finds a fraudulent transfer occurred, the court can undo the transfer and force a transfer of assets to the individual's creditors. The key factors considered in a fraudulent transfer case are:

- **Timing** – Did the asset transfer occur before or after the "claim" arose? If the claim existed prior to the transfer, the transfer will likely be considered fraudulent.
- **Sales and exchanges** – Did the transferor receive equivalent value back in exchange for making the transfer? If the individual receives equivalent value back, the risk of a fraudulent transfer determination is lessened.
- **Insolvency** – If the individual is insolvent (unable to pay debts) before the transfer, the transfer may well be considered fraudulent.

Various Asset Protection Opportunities

Every state and the District of Columbia have statutes protecting certain assets from creditors. Many states have enacted homestead exemption laws to protect all or part of a debtor's primary residence from the claims of creditors. Generally, these laws require that the homestead be personally owned as opposed to being held in a family limited partnership or some other type of business entity. The exemptions vary broadly from state to state.

- *Some states have a statute protecting life insurance and annuities from creditor's claims.* Statutes vary from state to state as to the amount of protection of life insurance (cash values and death benefits) and annuities, who must be named as beneficiary, etc. The law of the specific state should be reviewed.
- *Qualified retirement plans (e.g., defined benefit, profit sharing, and 401(k) plans, ESOPs, etc.) are generally protected from judgment creditors by virtue of ERISA's anti-alienation provisions.* In bankruptcy, qualified retirement plan assets should be protected from almost all creditors, while IRA and Roth IRAs are currently protected up to $1,362,800 per person. This amount is adjusted every three years for inflation and is scheduled to be adjusted again in April 2022.[1] However, some circumstances exist in which non-bankruptcy creditors may have access, such as alimony/child support or federal tax claims.

Where assets are not afforded statutory protection, entities can be established to protect assets from creditors as well as maintain control. However, asset protection may be lost if the owners do not follow the business formalities and respect the type of business entity.

- *Limited Partnership & Family Limited Partnership* - Only the general partners are personally liable for partnership debts. A limited partner's liability is limited to his/her investment. Each state's laws vary as to creditors' rights. In many states, a creditor's sole remedy against a limited partner is to get a charging order from the court. With a charging order, the creditor can get partnership distributions but has no right to vote or ability to get to the underlying partnership assets.
- *Limited Liability Company (LLC)* – In general, no member of the LLC is liable for LLC debts unless the member makes personal guarantees. Again, state laws vary but, in most states, judgment creditors of an LLC member cannot get to the LLC assets. They can only petition the court for a charging order. As mentioned above, a charging order generally gives creditors no voting power so the creditor cannot normally compel a distribution from the LLC. The creditor only has access if a distribution is actually made. Note that charging order protection varies by state. Some states including California and Florida have enacted legislation that would allow a court to liquidate the LLC interest to the extent necessary to satisfy creditors.
- *Corporations* – Generally, shareholders are not personally liable for corporate debts unless the shareholder makes personal guarantees. However, corporate stock may be subject to attachment by a creditor of the shareholder. A buy-sell agreement may allow the company or other shareholders to buy out the stock that a court may order distributed to a shareholder's creditor.

Another possible strategy is to use some type of trust arrangement, such as:

- *Qualified Personal Residence Trust (QPRT):* Offers effective asset protection for a residence. However, QPRTs come at a significant cost. The individual no longer owns the home and, if the home is the primary residence the individual may lose the capital gain exclusion and possibly the homestead tax exemption.
- *Foreign Asset Protection Trusts (also referred to as Offshore Trusts)*: A significant benefit of a foreign trust is that the creditor will generally have to commence an action in the foreign jurisdiction. Since foreign law will control the availability of those assets and certain other aspects, such as the statute of limitations, there is considerable discouragement for any creditor who wishes to seek recovery in the foreign jurisdiction.

[1] 11 U.S.C. § 522(n)

- *Domestic Asset Protection Trust (DAPT):* Normally, if a trust is "self-settled" (i.e., the grantor is also a beneficiary), the grantor's creditors will be able to access trust assets. However, several states, including Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming, have adopted laws that allow a grantor to be a beneficiary of a discretionary trust to some extent without jeopardizing creditor protection. The trust must be irrevocable. The trust document contains express language stating the trust will be governed by the laws of the state in which the trust will be located. Generally, some of the trust assets must actually be located in the governing state. The grantor can receive distributions from the trust, but only in the discretion of an independent trustee. The trust must contain a spendthrift provision, which means the language of the trust states the beneficiaries cannot transfer their interests to other parties (e.g. creditors). Prior to signing a DAPT the client typically has to sign an affidavit of solvency.
- *Discretionary Domestic Trust*: Created by a person for the benefit of others. In a discretionary trust, the grantor makes contributions to the trust, and a third party trustee (who is not the grantor) has complete discretion as to distributions to the beneficiaries, e.g., family members. The protection of the discretionary trust is based upon the nature of the beneficiary's interest, i.e. distributions are made only if and when the trustee decides to make them. Normally, if a beneficiary has no legal claim to trust property, then neither does the creditor. Discretionary trusts can be created during the grantor's life or at death according to the decedent's wills and/or revocable trusts. Many individuals prefer for the beneficiary to be the trustee and therefore, create a trust with distributions limited to those needed for the beneficiary's "health, education, maintenance and support" (HEMS). HEMS trusts may not offer as much asset protection as discretionary trusts, but may be the better option for some individuals.

Caveats

Note that the federal Bankruptcy Reform Act of 2005 added a provision that allows a bankruptcy trustee to avoid any transfer made within 10 years prior to the date of filing the bankruptcy petition if "such transfer was made to a self-settled trust or similar device . . ." and the "debtor made such transfer with actual intent to hinder, delay, or defraud." Legal commentators expect the existing bankruptcy laws may reduce the use of foreign trusts.

The National Conference of Commissioners on Uniform State Laws adopted the Uniform Voidable Transactions Act ("UVTA") in July 2014. The UVTA may adversely affect a debtor who lives in a non-DAPT state that has adopted the UVTA and makes a transfer to a DAPT in another state that has not adopted the UTVA. In comments accompanying the UVTA, the Commissioners indicated that because the transfer was made from a UVTA state, the transfer to the DAPT in another state could be voided without regard to whether the transfer affects an existing or identified creditor. This result is not certain, but counsel should be especially careful when a transfer to a DAPT in another state is made from a state that has adopted the UVTA.

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