THE NAUTILUS GROUP®

Asset Protection Strategies



Asset Protection Strategies

Asset protection strategies are gaining the attention of wealthy persons as the legal system is becoming increasingly subject to predatory and unwarranted litigation. 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

Threshold issues

The goal of asset protection planning is to insulate assets from claims of future creditors without perjury or tax evasion. Bankruptcy protection has a similar goal, and the two practice areas often operate in tandem. When a debtor has few assets, the bankruptcy route is likely preferable. When the debtor has significant assets, however, asset protection offers several solutions.

The four threshold issues that must be analyzed in each asset protection case are described below:

- **The type of debtor seeking asset protection planning.**

  If the debtor is an individual, is the individual married and is his/her spouse also liable for the debt? If the spouse is not liable, is it possible to enter into a postnuptial agreement to change the character of the spouses' assets from community property to separate property, or vice versa (called a transmutation agreement)?

  If the debtor is an entity, did any individual guarantee the entity's debt? Is there a statute available that will render any individual personally liable for the obligations of the entity? Is it likely that the creditor will be able to pierce the corporate veil or otherwise access the assets of the individual owners of the entity?

- **The nature of a creditor's claim.**

  Do specific claims exist or are asset protection steps taken due to a general desire to insulate assets from lawsuits? If the creditor's claim has been reduced to a judgement already, then what specific assets does the judgement cover or encumber? Is the claim dischargeable through bankruptcy?

- **The creditor's identity.**

  Is the creditor a government agency? Some government agencies, such as tax authorities or those providing health and human services, possess authority to seize assets where other government agencies do not.

- **The nature of the assets.**

  To what extent are the assets exempt from a creditor's claims? Some assets are granted protected status by statutes such as the exemption of the assets under a qualified retirement plan governed by the Employee Retirement Income Security Act of 1974 (ERISA), discussed in greater detail below.

Beware of fraudulent transfers

For asset protection to be effective, it is critical that there be no fraudulent transfer of assets. If a court finds that a fraudulent transfer occurred, the court can undo the transfer and force a transfer of assets to the debtor'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 in return equivalent value in exchange for making the transfer? If the individual receives equivalent value in return, the risk of a fraudulent transfer determination is reduced.

Insolvency

If the debtor is insolvent (unable to pay debts) before the transfer, the transfer may well be considered fraudulent.

Various asset protection opportunities

Asset protection strategy – statutory based

Every state and the District of Columbia has statutes protecting certain assets from creditors. The exemptions vary broadly from state to state. While the strategies listed do not include all asset protection possibilities, the list below provides an overview of some of the types of techniques available.

Homestead declaration

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.

Life insurance and annuities

Some states have a statute protecting life insurance and annuities from creditor's claims. The amount of protection of life insurance (cash values and death benefits) and annuities varies from state to state, and whether protection is afforded may be based upon additional factors such as who must be named as beneficiary and to what extent of the policy proceeds and/or cash value. The law of the specific state should be reviewed.

Qualified retirement plans

Most qualified retirement plans (e.g., defined benefit, profit sharing, 401(k), employee stock ownership plans, etc.) are generally protected from judgment creditors due to ERISA's anti-alienation provisions. In bankruptcy, qualified retirement plan assets should be protected from almost all creditors, while IRAs and Roth IRAs are currently protected up to $1,711,975 per person effective April 1, 2025, until March 31, 2028. This amount is adjusted every three years for inflation and is scheduled to be adjusted again in April 2028. However, some circumstances exist in which non-bankruptcy creditors may have access, such as alimony/child support or federal tax claims.

Asset protection strategy – entity design

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 business formalities and respect the type of business entity.

Limited partnership (including 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 seize the underlying partnership assets.

Limited liability company (LLC)

In general, no member of an LLC is liable for LLC debts unless the member makes personal guarantees. In most states, judgment creditors of an LLC member cannot get to the LLC assets. Creditors 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 from state to state. Some states, such as 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 between the corporation and its shareholders (or among the shareholders themselves) may allow the corporation (or other shareholders) to purchase the stock that a court may order distributed to a shareholder's creditor.

Asset protection strategy – use of trusts

Other possible strategies involve use of some type of trust arrangement.

Qualified personal residence trust (QPRT)

QPRTs offer 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 will lose the $250,000 capital gain exclusion and possibly the homestead exemption.

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, 19 states - Alaska, Connecticut, Delaware, Hawaii, Indiana, 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 must contain 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 must sign an affidavit of solvency.

Foreign asset protection trusts (FAPT; 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.

Discretionary domestic trust

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 the trustee decides to make them and when. Normally, if a beneficiary has no legal claim to trust property, then neither does his/her creditor. Discretionary trusts can be created during the grantor's life or at death according to the decedent's will and/or revocable trust. 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, or support" (HEMS). HEMS trusts may not offer as much asset protection as discretionary trusts but may be the better option for some individuals.

Concerns

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.

This writing is provided for informational purposes only. New York Life Insurance Company, its agents and its employees may not provide legal, tax or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies. These materials are prepared by The Nautilus Group®, a service of New York Life Insurance Company, and are made available to all Nautilus Group member agents, and, as a courtesy to select agents of New York Life Insurance Company. Membership is limited exclusively to the company's agents © 2019 New York Life Insurance Company. All rights reserved. SMRU 5018241 Exp. 6.30.2028