Asset Protection Planning: Where Sooner Really is Better Than Later!

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What is Asset Protection?

In today's litigious society, protecting assets from creditors and potential creditors has become a hot topic. Commonly filed lawsuits involve divorce, business disputes, failed real estate investments, vehicular accidents, and medical malpractice. The list of potential legal claims that any individual or business can face is virtually limitless. Asset protection planning can be very effective to protect valuable and hard-earned assets by moving them beyond the reach of creditors.

Sooner Can't Come Soon Enough

Asset protection planning and related actions can be very valuable, but only if they are completed timely. Otherwise, the planning likely will come to naught. And "timely" in the asset protection context means before there is a reason to believe there is a need to plan. Asset protection actions must be completed well before any potential claim actually surfaces in order to avoid a creditor's allegation that the actions constituted so-called "fraudulent conveyances." To avoid having asset protection actions from being nullified as fraudulent conveyances, the actions must have been taken not only before the creditor's claim actually arose, but also before the claim could have been reasonably anticipated.

Effective Asset Protection Requires Careful Planning

In addition to being done sooner rather than later, asset protection actions should be undertaken carefully, with a comprehensive consideration of the costs, risks, and benefits of such actions and with the aid of experienced advisors. Asset protection planning always should take into account the tax consequences of any proposed course of action. Certain transfers of assets may generate unexpected and unwanted gift taxes, run contrary to an established estate plan, or have unanticipated income tax effects. Consultation with a tax advisor in addition to an estate attorney is critical to any asset protection plan.

The More Common Tools of Asset Protection

Planning often can be simpler than anticipated. Although "asset protection planning" may conjure up images of off-shore trust accounts in exotic locales, such planning frequently can be accomplished "on-shore" and with less cost and complexity. If sufficient and affordable insurance can protect against a risk, then acquiring such insurance is likely to be the least expensive and easiest method of protecting assets. In some cases, however, insurance may be unavailable, insufficient, or prohibitively expensive. This can necessitate further planning.

After considering the option of purchasing appropriate insurance for anticipated risks and the potential tax consequences of alternative courses of action, numerous asset protection opportunities are available. Many of them are not complex but nevertheless are powerful. Some of these techniques are as follows:

- *Transfer of Assets to a Spouse*. A married individual with a higher risk potential than his or her spouse can transfer assets to that spouse. If the higher-risk spouse is sued, the transferred assets will belong to the other spouse and likely will be beyond the potential creditor's reach. However, there are significant estate planning and domestic relations law issues that must be considered before using this strategy. Otherwise, unanticipated subsequent events such as a divorce could impact the assets of the higher-risk spouse even more than the actions of a creditor.

- *Real Estate Owned as Tenants by the Entirety* . In North Carolina, if a married couple owns real property jointly as "tenants by the entirety," then a creditor of only one of the spouses typically cannot reach the jointly-owned real property. Therefore, ownership of real estate as tenants by the entirety can be an effective asset protection tool. Again, however, careful planning is necessary because, for example, the death of the less-at-risk spouse would result in automatic ownership of the entire asset by the surviving higher-risk spouse alone, thereby subjecting the asset to the claims of the surviving spouse's creditors.

- *IRAs and Retirement Plans*. IRAs and qualified retirement plans are exempt from the claims of creditors under federal and North Carolina law. Accordingly, one effective asset protection technique is to maximize contributions to such retirement accounts. There are circumstances, however, when assets ultimately must be removed from these protected retirement accounts. At that point, the amounts withdrawn may become subject to the claims of creditors.

- *Limited Liability Business Entities*. Another form of asset protection planning is to segregate the ownership of assets into multiple limited liability business entities such as corporations, limited partnerships, or limited liability companies rather than maintaining direct ownership. For example, if personally-owned real estate is placed in a limited liability company ("LLC"), with the owner obtaining an ownership interest in the LLC in return, then a judgment in favor of the owner's personal creditors would not become an automatic lien on the real estate asset as would be the case if the real estate was still in the individual's name. Moreover, the owner's other personal assets would be protected from claims and liabilities arising from the real estate now owned by the LLC. This asset protection technique can be enhanced if assets are segregated among several limited liability business entities.

More Complex Tools of Asset Protection

The above are powerful asset planning techniques. Once all of those techniques are considered and implemented, more sophisticated techniques also are available if additional protection is warranted. Some examples of more complex techniques are as follows:

- *Domestic Asset Protection Trusts*. In North Carolina, an individual cannot create a trust for that individual's personal benefit, transfer personal assets to the trust, and thereby protect the trust assets from the individual's personal creditors. However, several states such as Delaware and Alaska have changed their laws to allow such trusts. Complexity arises from establishing a trust under another state's laws and complying with the regulatory requirements of such laws, such as using a corporate trustee located in, and transferring assets to, the state whose trust laws are being used. However, the use of a trust created under another state's laws rather than those of a foreign nation can be appealing because the trust and the corporate trustee remain subject to the protection of U.S. courts, laws, and regulations.

- *Off-Shore Asset Protection Trusts*. Off-shore (non-U.S.) asset protection trusts work in a fashion similar to domestic asset protection trusts, except that the legal location of the trust and investment assets are outside of the United States and, at first blush, the jurisdiction of its courts, laws, and regulations. These trusts typically are formed in smaller countries that have enacted special legislation limiting the rights of creditors in order to entice owners to shelter their property in those countries to the benefit of their respective economies. These off-shore trusts typically are <u>not</u> effective and are <u>not</u> legal U.S. income tax avoidance vehicles. Extreme due diligence is necessary when considering off-shore trusts to ensure that the risk of placing assets in another country is not greater than the risk of creditor liability in the United States.

Conclusion

Asset protection planning may be accomplished in a multitude of ways, with varying degrees of complexity and expense. The most important factors are to plan very carefully and to take action before there is any reason to believe that actual claims may arise. In asset protection planning, much more than in other aspects of life, sooner really is better than later.

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