

# Asset Protection Planning: Steps You Should Consider Now

Written By **Virginia S. Carter** (vscarter@wardandsmith.com)

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Is the federal estate tax law going to change or be abolished under the Trump administration? Time will tell. One thing is certain: tax laws may change but the litigious nature of our society is not going away. Asset protection planning is a key motivator for many of our estate planning clients.

We hear scenarios over and over again in which a client has injured someone in an accident, is being sued for malpractice, is involved in a business dispute, owns rental property where someone was injured, or has a child in the middle of a divorce and custody dispute. What can you do to protect your or your family's assets if you become one of those unfortunate people?

Having this conversation in the wake of an incident or accident when a lawsuit is looming is less than ideal. Steps taken only then and deliberately intended to frustrate a known creditor almost certainly will be challenged as a fraudulent transfer and, if successful, will be voided by a court. The best time to address these risks is by planning and taking appropriate steps proactively. *The sooner the better!*

## The Lay of the Land: What is Protected by Law

As a matter of public policy, certain assets are exempt by law from the claims of creditors. North Carolina and federal law provide the following nonexclusive list of shields against those claims:

- Retirement account assets. Assets such as IRAs, Roth IRAs, qualified retirement plans, and qualified profit sharing plans are protected under North Carolina law and federal law. This is one of the main reasons (another reason being income tax benefits) that these are so popular. Note, however, that *inherited* IRAs, i.e., an IRA left to a child or received from a parent, may be vulnerable to creditor attacks after a 2014 United States Supreme Court decision finding that an inherited IRA was not protected from bankruptcy creditors. The result of that case is why you might consider using an IRA trust as part of your estate planning (see below).
- Certain Real Property. Real property that is owned by both spouses as "tenants by the entireties" is protected from the creditors of just one of the spouses. For many couples, this will protect their home from creditors, but there are important limits to keep in mind. If one spouse dies, this protection ends and the property becomes immediately subject to the liabilities of the surviving spouse. In addition, ownership as tenants by the entireties provides no protection against a creditor of *both* spouses. (And one spouse's accident can quickly become a problem for both spouses if, for example, a car involved happens to be registered in the non-driving spouse's name.)

If tenancy by the entireties does not provide protection, a married couple can protect up to \$70,000 of equity

in their home from claims of a joint creditor under North Carolina's "homestead" exemption. A single person is allowed \$35,000 of equity protection, which increases to \$60,000 in certain circumstances for people age 65 and over.

- Life insurance policies. The North Carolina Constitution provides strong protections for these policies during the insured's lifetime and after the insured's death. A policy on a person's life that names the person's spouse or children (or a trust for them) as beneficiary is protected during the insured's lifetime from creditors of the insured. This means that the cash value of the policy cannot be reached by a creditor. In addition, proceeds that are paid after death are exempt from the claims of the insured's creditors, as long as the beneficiaries are the spouse and/or children of the insured (or a trust for them). Note, however, that proceeds are *not* protected from creditors of the beneficiary spouse or child, which is one reason to consider using a trust as part of your estate planning (see below).
- Assets in 529 Plans. These assets are exempt from your creditor's claims in an amount up to \$25,000 as long as the plans were not funded just in order to thwart one of your creditors. If each spouse owns a 529 Plan, North Carolina law protects a maximum of \$25,000 per spouse for *all* 529 plans—*not* per plan or per child.
- Other. There are various other limited specific protections provided by North Carolina law. For instance, \$3,500 of value in a car, household items of up to \$9,000, and professional tools of up to \$2,000 are protected.

As you can see, the exemptions provided by law are fairly limited. In addition to the specific limits noted above, notice what is not protected:

- Joint or individually owned bank accounts;
- Joint or individually owned non-qualified investment and brokerage accounts;
- Individually owned real property in excess of the small homestead exemption;
- Individually owned investment property; and,
- Personal property in excess of the small limits mentioned above.

### **Low-Hanging Fruit: Simple Steps You Can Take**

There are certain fairly simple steps you can take to address your assets' vulnerability to attack by potential creditors.

#### Insurance.

First and foremost, you should review your liability insurance policies and make sure that you have sufficient coverage in place for your assets and risks. Understand the limits of your coverage. An umbrella policy can be a huge benefit. Insurance, however, may be costly, have coverage gaps, or simply be unavailable.

#### Ownership of Assets.

Married persons who are at a higher risk of being sued due to their profession may want to consider transferring ownership of their personal assets to the "less risky" spouse. For this to be effective against the creditors of the at-risk spouse, the at-risk spouse must fully transfer ownership and control to the other spouse. Of course, this assumes that the couple has a strong marriage, as the transfer of assets in this manner could impact the division of assets in the event of divorce. In addition, note that if the "less risky" spouse dies and assets pass to, or back to, the surviving spouse outright, this asset protection strategy is defeated, which is why it is important to consider using a trust as part of estate planning.

#### Limited Liability Companies.

If appropriate, a limited liability company can be set up to hold certain assets. In the estate planning world, we often use LLCs as part of an estate tax reduction strategy and as a way to orderly transfer assets to the next generation. But there also are important asset protection benefits of an LLC, as long as you observe and respect the LLC legal formalities.

A limited liability company can isolate the liability associated with a particularly risky asset. This is an important strategy for assets such as investment real estate. Holding such properties in your individual name is ill-advised because a lawsuit relating to the property, such as injury to a tenant, employee, or delivery person, could jeopardize all of your personal assets. If the property is owned by an LLC, the injured party can only reach the assets of the LLC, not your other assets. In North Carolina, this is true even if you are the sole member of the LLC.

Conversely, a second, equally important, aspect of an LLC is that your personal creditors typically cannot reach assets that are owned by your LLC. For example, a creditor that obtains a judgment against you personally can execute on that judgment to obtain your assets. If you own an asset indirectly through an LLC, however, the creditor is limited to a "charging order" entitling it to a right to collect *distributions* made from the LLC to you, but not the underlying assets of the LLC. As a member of the LLC, you likely have some ability to control distributions. Wages paid to you as a member of the LLC are not considered distributions.

#### "Spendthrift" Trusts.

A simple option that everyone should consider is using trusts in estate planning. A "spendthrift" trust, typically an irrevocable trust under which a trustee has discretion over distribution of income and principal to a beneficiary, is exempt from the claims of the beneficiary's creditors. Instead of assets passing *outright* to a spouse or child during lifetime or at death, the assets can be directed to a spendthrift trust for the beneficiary.

An independent trustee with absolute discretion over distributions provides the greatest asset protection, but the trust also can be designed so that the beneficiary can serve as trustee without losing asset protection. Essentially, a beneficiary potentially can have control over, and access to, the assets, but with valuable asset protection. Considering the strong asset protection afforded by a spendthrift trust, even parents with mature, responsible children should consider using trusts for children in their estate plan.

#### IRA Trusts.

As noted above, prior to 2014, it was believed that an inherited IRA afforded the beneficiary the same protection from creditors' claims as the IRA owner. After the 2014 Supreme Court ruling, however, this is no longer certain. An IRA trust is a special trust designed to preserve the "stretch" treatment of an inherited IRA for income tax purposes, while providing the protections of a traditional spendthrift trust. You can read more about IRA trusts here.

### **More Complex Strategies Are Available**

The above strategies are powerful and may accomplish most of your asset protection goals, but if additional asset protection is warranted other more complex measures can be taken such as:

#### Lifetime Intervivos QTIP Trust.

Under North Carolina law, a "self-settled" spendthrift trust (meaning a trust established by a grantor for the benefit of the grantor) is *not* protected from the grantor's creditors. However, if you are married, you can create an irrevocable trust that benefits your spouse for your spouse's lifetime. During your spouse's lifetime,

you will have indirect access to the trust through your spouse as long as you remain married to each other. Because you will not be a beneficiary of the trust, your creditors cannot reach it.

Even more noteworthy, at your spouse's death, the remaining assets can pass into a trust benefitting you that also is exempt from your creditors. This essentially is a round-about way of creating a self-settled spendthrift trust, but the North Carolina trust code now exempts this strategy from the general prohibition (see below). This can be a powerful tool for asset protection under North Carolina law.

#### Domestic Asset Protection Trust.

As of May 2017, 17 states, but not North Carolina, have statutes recognizing and permitting the creation of self-settled spendthrift trusts, also known as "domestic asset protection trusts." These trusts are irrevocable trusts with an *independent* trustee who has absolute discretion over making distributions to a class of beneficiaries that includes the grantor.

Although North Carolina law does not permit such trusts, a North Carolina resident can nevertheless establish a domestic asset protection trust in one of the 17 states that do recognize such trusts. The statutory requirements vary by state, but typically, the trust must have a corporate trustee located in the state where it is created and will be subject to the laws of the state where it is created.

North Carolina's adoption of the Uniform Voidable Transactions Act ("UVTA") in 2015, however, has created some question as to whether a domestic asset protection trust established by a North Carolina resident in another state will be effective to protect the North Carolinian's assets. The UVTA provides that the governing law is the local law of the debtor's jurisdiction when a transfer is made, and further provides that a transfer is voidable as to a creditor, even if made before the creditor's claim arose, if the transfer was made with "intent to hinder, delay or defraud any creditor."

According to the comments of, the National Conference of Commissioners on Uniform State Laws, the drafter of the UVTA, a transfer by an individual to a domestic asset protection trust is voidable *per se* if the individual lives in a state that does not recognize such trusts. Essentially, this could mean that such trusts are ineffective in North Carolina. Most practitioners argue that this is simply incorrect—whether a domestic asset protection trust is recognized in North Carolina should be determined by that state's conflict of laws rules, rather than the UVTA. Nevertheless, the comments have added some uncertainty to this strategy.

#### Offshore Asset Protection Trust.

Offshore asset protection trusts are similar to domestic asset protection trusts, except that the trust is administered and governed by the laws of an offshore jurisdiction and the trust's assets are held in an offshore financial institution. These trusts are formed in one of a number of smaller countries (often islands in the Caribbean, the Pacific, or the English Channel) which have enacted special legislation promoting the effectiveness of asset protection trusts by limiting the rights of creditors, the reach of fraudulent conveyance laws, and the recognition and enforcement of judgments rendered by United States courts. These statutes, together with the logistical difficulties involved in pursuing a claim in a foreign jurisdiction, make the assets held in an off-shore asset protection trust highly unattractive to creditors. Obviously, there are risks in placing your assets in the hands of a foreign trustee in a foreign jurisdiction that is beyond the reach of United States laws (and the protections offered by United States institutions such as the Federal Deposit Insurance Corporation). Competent and trustworthy trustees and local counsel are essential if this course is chosen.

### **Conclusion**

There are a number of asset protection strategies that may be available to you. Being informed and aware of

your exposure will help you decide what asset protection strategies are the best suited for you. Simple steps if taken now can greatly improve your position against attacks of creditors—but the key is to act now!

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