

Planning for the Worst and Hoping for the Best: The Use of Asset Protection Strategies in Estate and Business Planning

presented by

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Historical Legal Basis

[E]very State in this Union has passed statutes by which a part of the property of the debtor is **exempt from seizure** [for] the payment of his debts....**To property so exempted the creditor has no right to look**...as a means of payment.

-Nichols v. Eaton, 91. U.S. 716 (1875)

Who Needs Asset Protection?

- **Everyone**, but particularly...
 - High risk professionals
 - High risk position
 - High risk assets
 - High risk profile
 - High risk domicile (personal or business)
 - High risk business (product liability)

Creditors Come in All Shapes and Sizes

- General litigation
- Divorce
- Risk of business failure
- Environmental claims
- Malpractice exposure
- Many other sources of potential liability

What About Liability Insurance?

- Business and personal coverage
- Limitations on coverage:
 - Uninsurability or unaffordability of coverage
 - Potential judgments that might exceed coverages
 - Exclusions and other gaps in coverage

General Observations

- Added complexity and uncertainty due to interplay of various state and federal laws
- No pending or threatened creditor claims; must not violate fraudulent transfer laws
- Greater chance of success if implemented well in advance and have a separate legitimate purpose associated with the plan
- Settlement or negotiation leverage

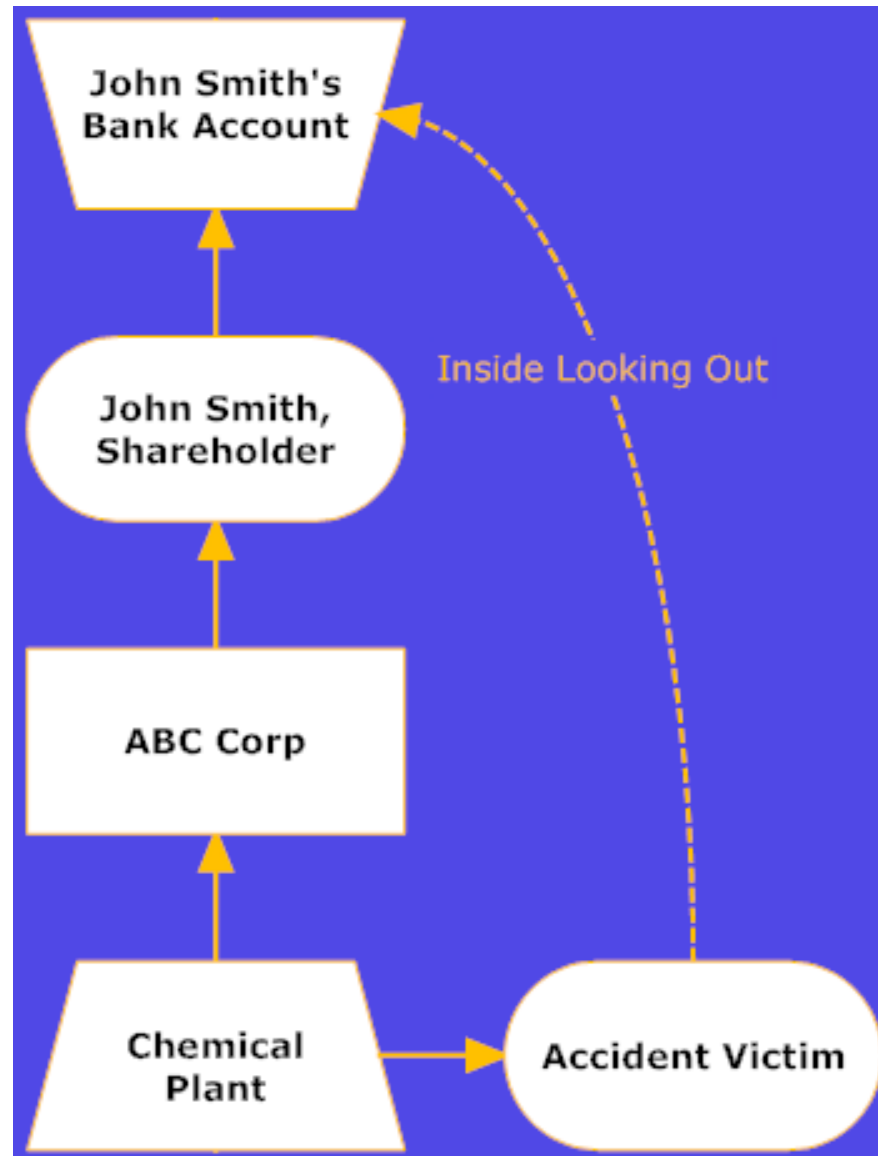
Goals

- Establish obstacles to make it more difficult to reach an asset
- Limit the rights of a creditor with respect to the asset
- Convert marketable liquid assets into unmarketable illiquid assets
- Segregate assets
- Remove assets from balance sheet
- Protect family members from the claims of the individual's creditors
- Increase negotiating position

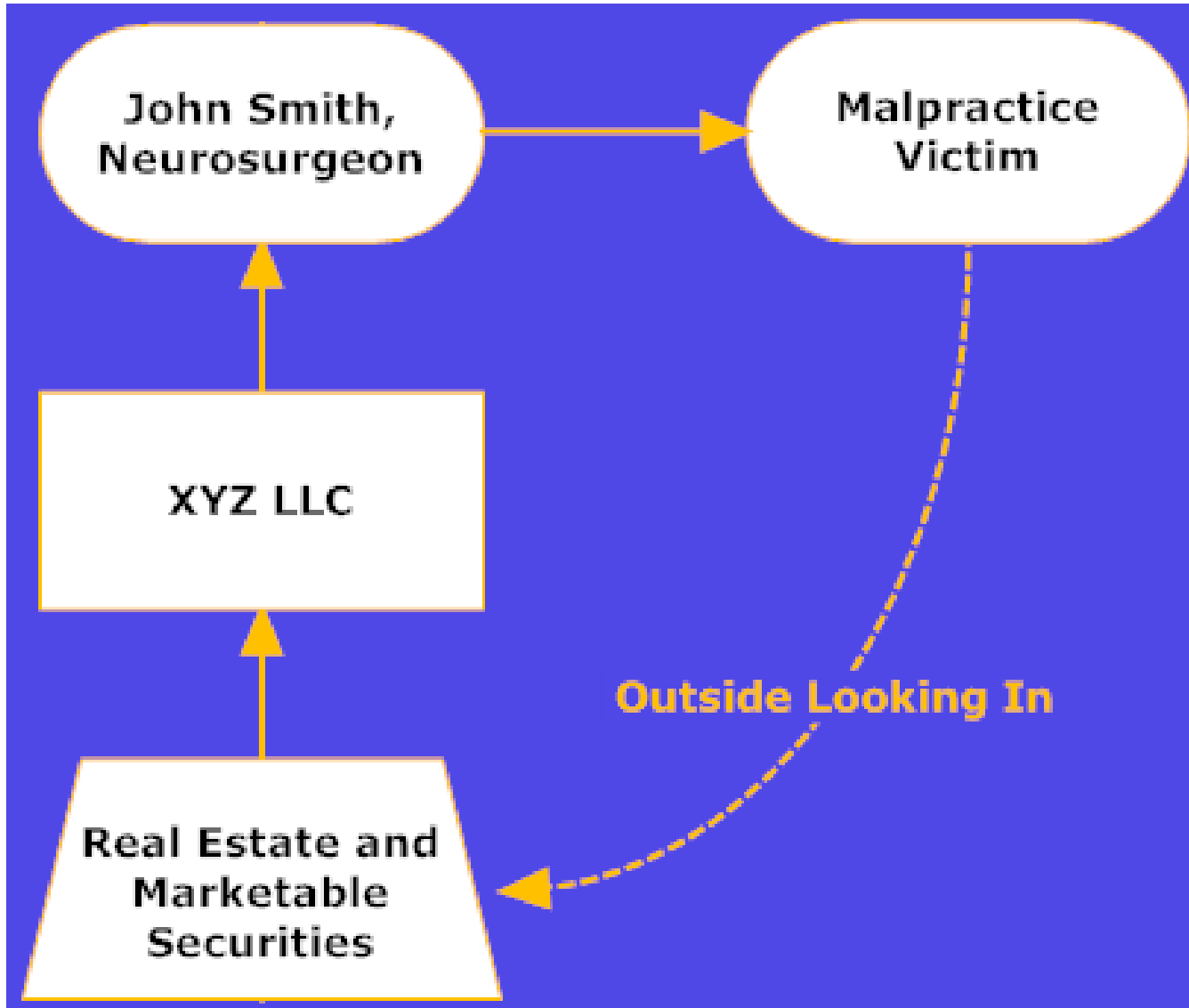
Piercing the Corporate Veil and Other Business Owner Risk Issues

- Internal Creditors – inside looking out
- External Creditors – outside looking in
- Assume already using limited liability entity to protect against internal creditors

Internal Creditors



External Creditors



Fraudulent Transfer Law

- Uniform Fraudulent Transfer Act (soon to be renamed Uniform Voidable Transactions Act)
- Actual Fraud (intent to hinder...)
- Constructive Fraud (insolvency)
- 4 Year Time Limit

Bankruptcy Issues – NC Exemptions

- \$35,000 value in personal residence
- \$5,000 in personal property
- \$3,500 in one motor vehicle
- \$5,000 in household goods
- \$2,000 in tools of the trade
- Health aids
- Certain life insurance, college and retirement funds, alimony, child support and proceeds from injury claims, including private DI payments

Assets Protected Under North Carolina Law

- Exemptions
 - Life Insurance
 - Tenants by the Entireties
 - Retirement accounts
 - 529 Plans

Life Insurance Policies Owned by an Individual

- Constitutional protection
- Unlimited amount
- Protects insurance and proceeds for sole benefit of spouse and/or children
- Don't let proceeds get paid to the estate!
 - Failure to designate usually means it goes to estate
- ILIT

Tenancy by the Entirety Real Property

- Owned by husband and wife
- Applies to any real property, not just personal residence
- No protection from IRS liens or joint creditors (vicarious car accident liability?)
- Note: creditor protection lost upon death of one spouse, divorce or sale
- Does not apply to joint personal prop.

Retirement Plans (including IRAs)

- Creditor protection for both IRA and ERISA-qualified plans
 - Nondeductible IRA contributions - \$5,500 (+\$5,500 for spouse); \$6,500 for 50 and over
- No protection for commercial annuities?
- Inherited IRAs – Clark v. Remeker; see NC exemptions

Retirement Plans (including IRAs)

- Individual retirement plans
 - Includes any plan treated in the same manner
 - Includes Roth and traditional
 - AND NOW.... Might include withdrawals from plans as well...? *Kinlaw v. Harris*, 702 S.E.2d 294 (N.C. 2010).

529 College Savings Plans

- Limited protection
- Protection designed for funds likely to be used for college expenses ((i) limited to \$25K, excluding contributions within the past 12 months, except those made pursuant to an established pattern, (ii) only for child of the debtor, and (iii) “will actually be used for the child’s college or university expenses.”)
- Consider putting in spouse’s name
- Consider a 529 plan trust

Asset Protection Strategies – Transfer of Assets to Spouse (or to Trust for Spouse)

- Transfer from “at risk” spouse to other spouse (can you tell who is who?)
- Unlimited marital deduction
- Fraudulent transfer limitation
- Equitable distribution issue

Asset Protection Strategies – Transfer of Assets to Children (or Trusts for Children)

- Traditional estate planning purpose
- Outright v. in trust
- Gift tax considerations
- Pattern of gifting
- Cessation of use and control

Asset Protection Strategies - Estate Planning

- Revocable living trust – good asset management and probate avoidance tool; but useless for asset protection (or Medicaid planning)
- Insurance trust
- Gift trust for issue or other beneficiaries (e.g., GRAT, IDGT)
- Charitable trust
- Special Needs Trust

Planning Steps That Can Be Taken By Other Family Members

- The North Carolina "Spendthrift" Trust Statute
 - Trust that is not subject to attachment by creditors
 - Spendthrift provision
 - Discretionary or support trust
 - Protective trust

Planning Steps That Can Be Taken By Other Family Members

- "Skipping" the Potential Bankrupt in Favor of Children or Other Beneficiaries
- Restructuring the Will and Trust of Parents to Prevent the Potential Bankrupt from Having Direct Ownership of Assets

Asset Protection Strategies – Qualified Disclaimers of Inheritances

- Basic requirements
 - Irrevocable written refusal to accept interest
 - Within 9 months
 - Before receiving any benefit
 - Filed with appropriate parties
 - Must pass without disclaimant's direction

Asset Protection Strategies – Qualified Disclaimers of Inheritances

- Bankruptcy impact
- Ineffective against tax liens (Drye case)
- Bottom line – not something a client should plan or count on, but might work in the right situation

Asset Protection Strategies – Possible Protection of Assets Owned by "Family" LPs and LLCs

- North Carolina LLC and Partnership Law
- Charging Order Regime
- Ehmann Case
- Document Drafting and Structure
- Single Member LLCs do not work for this purpose
- LLC taxed as an S corporation

Domestic Asset Protection Trusts (DAPT)

- Certain states have enacted legislation intended to permit protection for self-settled trusts.
- Among other things, must be
 - Irrevocable
 - Governed by the law of that state
 - Trustee in that state
 - Substantial amount of administration in that state
 - Limited interest of grantor in trust

Foreign Asset Protection Trusts (FAPT)

■ Advantages:

- No full faith and credit
- Creditors can't find a lawyer (e.g., conflicts, no contingency fees)
- Must retry cases, won't domesticate judgments
- Shorter statutes of limitations/weaker fraudulent transfer laws
- Greater retained interest permitted (some even permit revocable trusts)

Foreign Asset Protection Trusts (FAPT)

- Disadvantages:
 - Concerns about political and economic stability
 - Foreign trusts have substantial reporting requirements (and substantial penalties for failure to do so)
 - US court hostility (contempt findings)
 - Ethical problems in finding a lawyer to help
 - Willing to send all of your assets?

Asset Protection Strategies – Prepayment of Mortgages and Other Debts (Including Nondischargeable Debts)

- Fraudulent transfer law applies
- Pay debt on tenancy by the entirety property (if only one spouse is “at risk”)
- Pay nondischargeable debts

Asset Protection Strategies – Equity Stripping

- “Friendly loans”
- Boot collateral
- Premium financing
- Accounts receivable financing
- Captive insurance companies

Conclusion

- Be proactive.
- Get clients focused on the need for a quality team of advisors, including a financial advisor, estate planning attorney and CPA.
- Look for creative solutions.
- Be a trusted advisor, not a service provider.