PRACTICAL ASSET PROTECTION

YORK HOWELL & GUYMON

ATTORNEYS AT LAW

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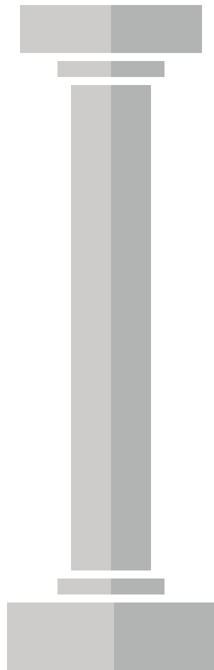

What exactly is asset protection?

Asset protection is an essential pillar of any estate plan. Asset protection is used to protect the assets of your estate while providing additional assurance and stability to your estate plan.

A common misconception is that asset protection involves hiding assets or making misrepresentations in order to avoid legitimate debts and obligations. However, when used properly, asset protection is simply a way of planning ahead to protect assets from the risks associated with unrelated business activities or ventures. This is done with full disclosure. There is no hiding of assets; the assets are simply owned and managed in a more strategic way. This strategy compartmentalizes risk. The best asset protection strategy can be fully disclosed and yet still fully effective.

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PART 1: WHY DO WE NEED ASSET PROTECTION?

Our world is full of risks and these risks come in different forms and from different sources. The risks associated with managing your estate are no different. The first step to developing any asset protection plan is to understand both the nature of your assets and the nature of your risks. Different assets are susceptible to different levels of risk, and each individual faces a wide variety of risks depending on his/her occupation, age, marital status, hobbies, lifestyle, etc.

- ASSET BASED RISK

- DIRECT RISK

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TWO CATEGORIES OF RISK:

Asset Based Risk

Asset based risk is risk arising from the assets you own. For example, assets used in the course of business such as an apartment building create its own set of risks. There is no reason that the risk created from owing an apartment building should jeopardize your family home. Proper diversification of ownership and compartmentalization will help isolate these risks from each other.

Direct Risk

Direct risk is risk that arises from your personal and professional activities. The most common example of this type of risk involves certain professional (medical doctors, attorneys, CPAs) who risk malpractice lawsuits that could directly jeopardize personal assets. While this is the most common example of direct risk, everyone faces direct risks regardless of his/her profession (car accident). We can help implement a variety of different strategies to reduce this type of risk.

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FRAUDULENT CONVEYANCES:

Proper asset protection will often involve the transfer or conveyance of property from one entity to another. The goal of proper asset protection is to properly title assets in a way that compartmentalizes the risk. However, fraudulent transfers are those transfers with actual intent to hinder, delay, or defraud a creditor. A creditor is anyone with a claim, or a right to payment, whether or not that right is reduced to a judgment.

A transfer that is fraudulent may be unwound so that asset protection is not provided.

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SOME FACTORS TO WATCH OUT FOR:

- Does the transfer leave the debtor insolvent?
- Is the transaction strictly with an insider (i.e., family member, business partner)?
- Was the transaction concealed and not disclosed?
- Had the debtor been sued or threatened with a lawsuit?
- Did the debtor transfer substantially all assets in his/her name?
- Has the debtor absconded?
- Has the debtor removed or concealed assets?
- Was the debtor paid considerably less than the actual value of a transferred asset?
- Did the transfer of property happen shortly before or shortly after the substantial debt was incurred?
- Did the debtor transfer essential business assets to someone who then transfered them to an insider?

While no single factor above necessarily proves fraudulent intent, if several factors exist for a transaction, then the transaction could appear fraudulent. The most important act you can do to make sure your asset protection plan is effective is to plan early. A good asset protection plan is in place long before any need arises.

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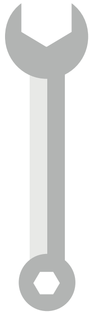

After analyzing your assets and risks, we want to identify the appropriate tools to help protect your assets from your risks. There is no one size fits all approach to asset protection.

Each one of these tools provides different levels of asset protection and are used in different ways. It may be helpful to picture these tools on a sliding scale of asset protection. On one end, a person owns 100% of assets in his/her own name. This provides virtually no asset protection beyond the built in statutory protections for assets. On the other end of this scale is a person with no assets in his/her own name. This person could essentially be judgment proof. In between these two extremes we will use tools to provide a balanced and open plan to protect your assets.

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STATUTORY PROTECTIONS:

When analyzing your assets, we first look for those assets with “natural” or “built in” asset protection. Most states recognize that certain assets are so important or essential as to warrant this natural protection. For example, life insurance is generally protected as well as qualified retirement plan assets (401K and IRA) up to a $1 million cap. Annuities are also generally protected.

Other protections include exemptions for your home, although this exemption amount differs from state to state. For example, in Utah, $40,000 of your home’s equity is protected while other States like Texas and Florida offer dramatically higher levels of protection. Other personal property such as refrigerator, freezer, stove, sewing machine, beds and bedding, can be exempt.

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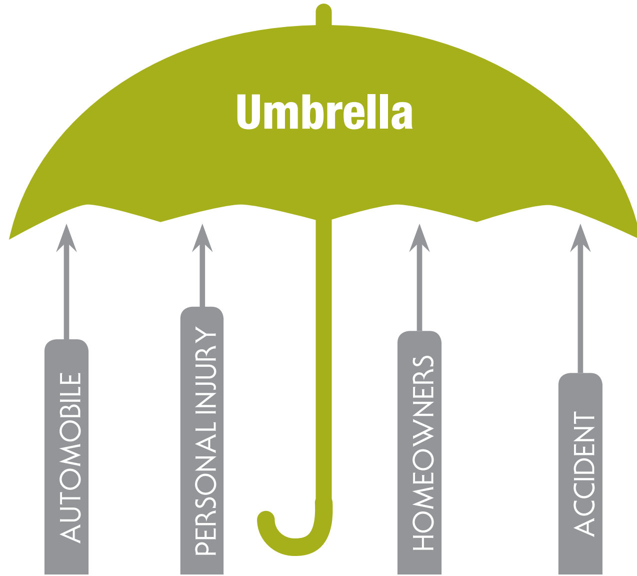

INSURANCE:

Insurance is a basic but important part of any estate plan. Policies to protect your home and automobile from those risks directly related to owning those assets are essential. Additionally, malpractice insurance for professionals or directors and officers insurance can help protect against direct risk resulting from professional or business activities. Finally, umbrella insurance policies can be used to dramatically increase your insurance protection at relatively little additional cost.

While insurance is an important tool in protecting your assets, insurance will only protect certain kinds of risk and only up to certain set amounts. That is why, in addition to comprehensive insurance coverage, it is important to consider other asset protection tools to enhance the overall protection for your assets.

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OWNERSHIP OF ASSETS:

The old rule of diversification of investments holds true for protecting your assets. Similar to reducing risk from diversification of your stock portfolio, diversification of your asset ownership can reduce risk. A simple way to do this is to separate assets between spouses to spread the risk. The spouse with the lower risk should own the bigger assets. Do you own a boat or other recreational vehicle? Do you own rental property? You should carefully consider how you want these assets to be owned. Brokerage accounts should also be considered for title diversification. You also want to avoid joint tenancy with other people.

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COMPARTMENTALIZING RISK WITH ENTITIES:

Business entities can be used not only to effectively and efficiently own and operate business activities but also to compartmentalize risk. Think of assets as either hot assets or cold assets. Cold assets are those whose risk of loss is limited to the investment, that is, stock in publicly traded company. If you buy stock in Apple Computers, you may lose your entire investment if Apple goes bankrupt, but you are not otherwise liable for the debts and obligations of the company itself. The same is true for most bonds and mutual funds.

Hot assets, on the other hand, are those whose potential risks of loss could exceed the amount of the investment. For example, owning a rental property could result in losing more than just the equity in the underlying rental property if the owner is sued for a personal injury that occurred on the property.

Business entities can be used to "cool down" assets by compartmentalizing the risk associated with a particular venture by having the entity itself engage in the business activity or investment. Compartmentalized and distinct business activities can be shielded from one and other if something goes wrong in one business, so as not to expose the other assets to that liability. Of course, to the extent you personally guarantee the debts and obligations of the business or otherwise assume the liabilities of the company, the protection can be lost.

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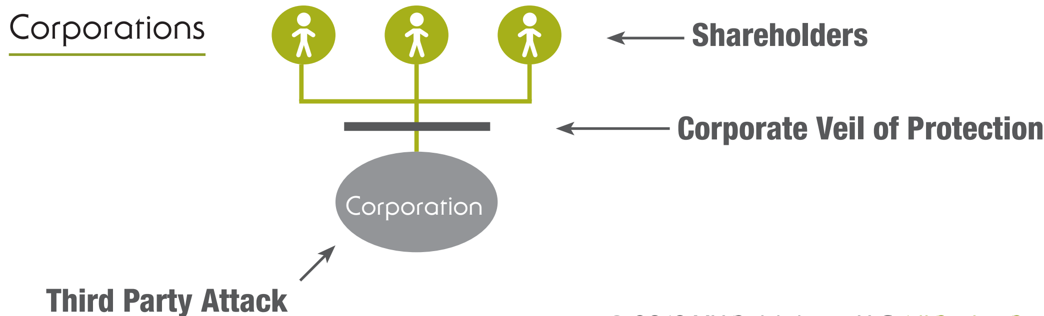
TYPES OF BUSINESS ENTITIES:

Corporations – Corporations have been used by business owners and investors for hundreds of years and are one of the most common business structures. A corporation is a separate business with a separate legal identity from its shareholders (owners). Corporations have several important characteristics that are attractive to business owners and investors. Shareholders of a corporation enjoy limited liability which means the shareholders are not personally subject to the debts and liabilities of the corporation and are not personally responsible for the corporation's activities. A corporation has centralized management where ownership through shareholders is distinct from the management operations provided by the management team, customarily referred to as the board of directors. A corporation will typically also have officers who conduct the day-to-day operations of the corporation.

Note: It is very important that corporations follow all of the necessary corporate formalities and state law requirements in order to preserve their corporate veil of protection for the shareholders.



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Limited Liability Companies (LLCs) – LLCs have numerous characteristics that make them attractive to small business owners and investors, the first of which is limited liability for all members. While investors in Corporations are shareholders who receive shares for ownership of their investments, investors in LLCs are members who receive units or percentage of ownership. The limited liability protection provided to LLC members allows both the passive investment members and those members taking an active role in the administration and management of the business to enjoy limited liability protection. LLC members, such as Corporation shareholders, can enjoy limited liability to his or her interest or investment in the company although a member can be found personally liable in the event of any personal guarantee made by the member.

The LLC provides great flexibility for its members. State laws governing LLCs generally provide wide latitude for members to dictate the terms of operation and to reduce those terms to an operating agreement. In the absence of an operating agreement, state laws generally provide default rules for administration, but the members can often contract around or out of those default rules. This flexible structure combined with limited liability generates large opportunity for various types of investors, whether passive, active, preferred, or a combination of investment options.

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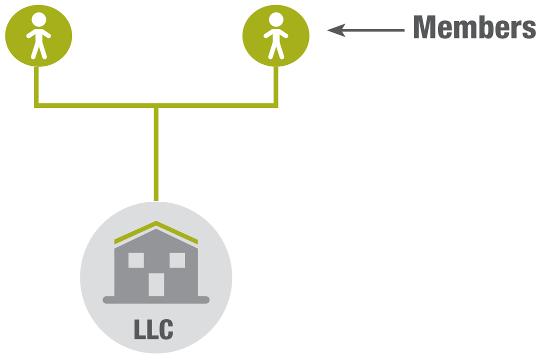
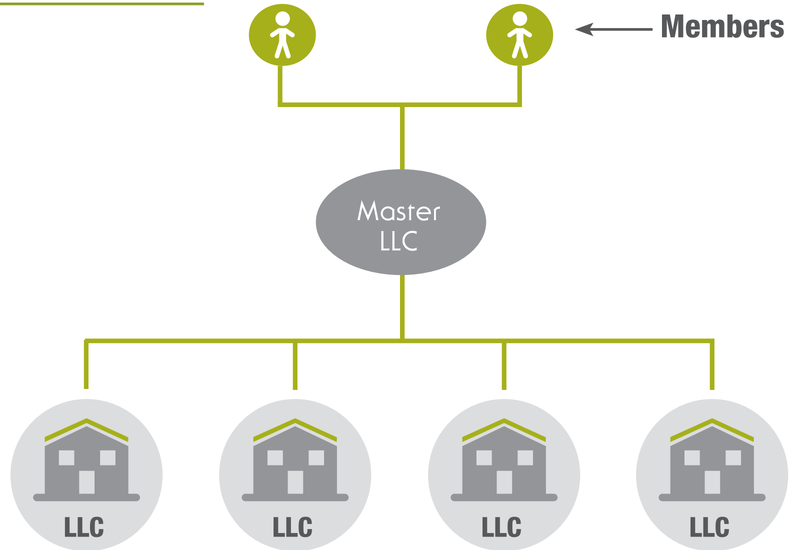
LLCs can be simple or complex.





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Family LLCs. Family LLCs can be used to hold cold assets and yet still offer asset protection benefits to the individual members. Instead, the individual members of the LLC only own a "bundle of rights" as outlined in the LLC Operating Agreement. The Operating Agreement will define both rights of members (i.e. rights to distributions, rights to sell interest, etc.) and restrictions on membership (generally restricted to blood members of the family and their spouses) in order to build strong protections for those assets held by the LLC.

To understand the how LLCs help protect both the assets inside and the individual members, it is important to understand Inside vs. Outside creditors.

An **Inside Creditor** is someone with a claim arising from an asset or activity within the LLC. For example, if the LLC owns a rental property, a claim arising from one of the tenants of that property would be considered an Inside Creditor. That Inside Creditor could go after assets within the LLC, but they would be limited against going after members of the LLC up to their capital investment.

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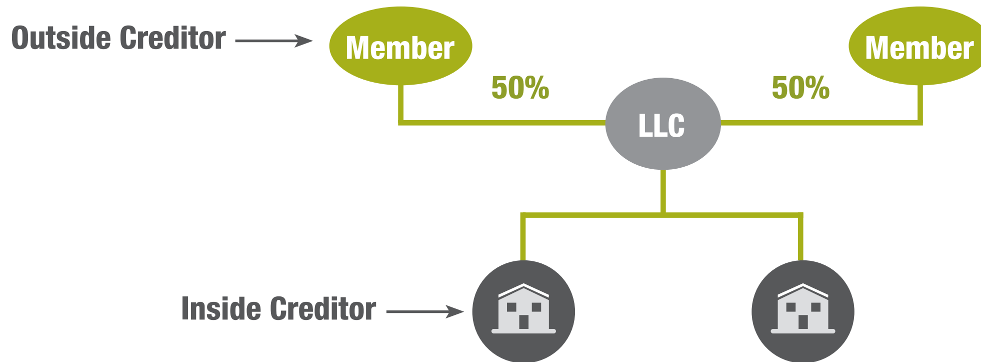
In contrast, an **Outside Creditor** is someone with a claim against a member of the LLC, not arising from activities related to the LLC. These Outside Creditors cannot go after assets held within the LLC. Instead, such creditors are limited to attach the debtor's distributions from the LLC, also known as a charging order. If no distributions are declared, the creditor cannot attack the assets of the LLC, nor can they affect the management or operations of the LLC.

In order to obtain the benefit of a charging order we strongly recommend the use of multiple member LLCs. Single member LLCs offer some protection against Inside Creditors. However, in most states the charging order protections against Outside Creditors are lost with single member LLCs. Adding another member to a LLC, even if it is only a small percentage interest, can add additional protection against Outside Creditors.



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TRUSTS:

Trusts have been used for hundreds of years to effectively hold, manage, and protect assets. Trusts are the only type of entity that can engage in business and own property without any type of public filing. Trusts are established by one or more individuals called Settlors who determine the terms and conditions in which the Trustees hold and manage assets for the benefit of the Beneficiaries of the trust. Trusts divide the assets they hold into three separate components:

Control – The control of assets owned by a trust is given to the Trustee(s) of the trust (described in more detail below). They are responsible for the investment, management, and distributions of the assets of the trust to the Beneficiaries pursuant to the terms of the trust.

Use – The Beneficiaries have the ability to the use of the assets of the trust as determined by the Trustees. A trust can own real property, business interests, marketable securities, and even vehicles and allow the Beneficiaries of the trust the right to use and enjoy those assets.

Ownership – Although the Trustees manage and control the assets and the Beneficiaries have the ability to use and enjoy the assets, the Trust itself is the legal owner of the assets. This means that properly structured trusts can hold and manage assets for the benefit of Beneficiaries without the assets of the trust being subject to the claims of potential creditors of either the Beneficiaries or the Trustees.

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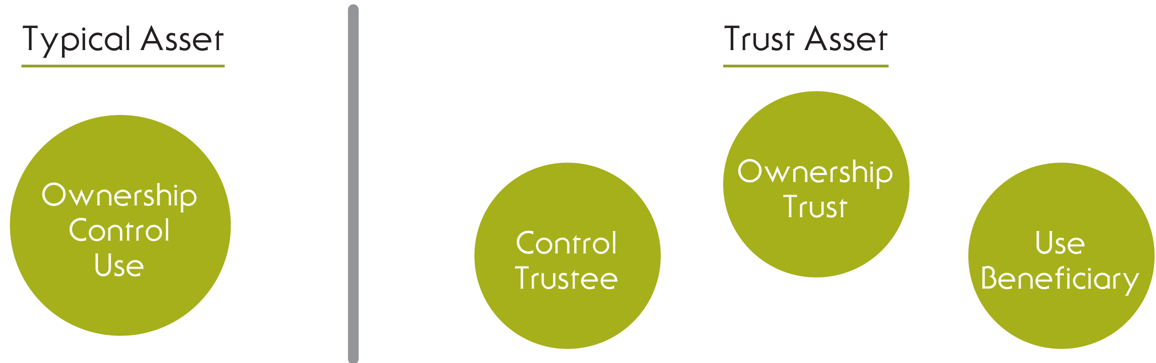
TYPES OF TRUSTS:

Revocable trusts are trusts established by a Settlor while maintaining the right to revoke the trust or contributions to the trust. While revocable trusts do not provide any direct asset protection for the Settlor, assets held inside a spouse's revocable living trust can generally be protected against potential claims against the other spouse. For example, we may recommend that your personal residence be held in one spouse's trust in order to help protect it from the potential claims of the other spouse. Typically the spouse with the lower risk will hold the residence in his or her revocable trust.

On death, a revocable trust will become an irrevocable trust. If properly drafted, this trust can become protected from the claims of creditors of a Trustee or Beneficiary using a spendthrift clause. A properly drafted and implemented spendthrift clause will ensure that assets within the trust are not subject to the claims of the beneficiaries until a distribution is made to that beneficiary.



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SELF-SETTLED TRUSTS: DOMESTIC ASSET PROTECTION TRUSTS

A **Self-Settled Trust** is a Trust established by a person (a "Settlor") who is also a beneficiary of the Trust. Traditionally, these Trusts suffered from two major problems: first, assets of the trust were subject to the Settlor's creditors; second, the duration of the trust term was limited. However, certain states have recently adopted laws which allow a person to establish a trust for the benefit of himself/herself, a spouse, and children, without those assets being subject to the claims of future potential creditors. These trusts are known as Domestic Asset Protection Trusts ("DAPTs") are powerful tools in asset protection. Of the states currently authorizing DAPTs, Alaska, Delaware, Nevada, South Dakota, and Utah offer the best protections.

In general, there are two types of DAPTs. First, **Incomplete Gift Trusts** continue to be included in the estate for estate tax purposes. These trusts allow the Settlor to reserve the right to veto any distributions to any beneficiary and to designate in the Settlor's Will who shall receive the future benefits of the trust. Upon death of the Settlor, this Incomplete Gift Trust is part of the Settlor's taxable estate, but the Settlor will not be subject to any gift taxes when the trust was formed or funded.

In contrast, **Complete Gift Trusts** will not be included in the estate for Settlor's estate tax purposes. However, the Settlor waives the right to veto distributions as described for Incomplete Gift Trusts. While this Complete Gift Trust will not be included in the Settlor's estate at death, funding it is subject to gift taxes which may be reduced or wholly exempted based on applicable gift tax exemptions. Each person's individual estate planning needs will help determine what type of DAPT should be used.

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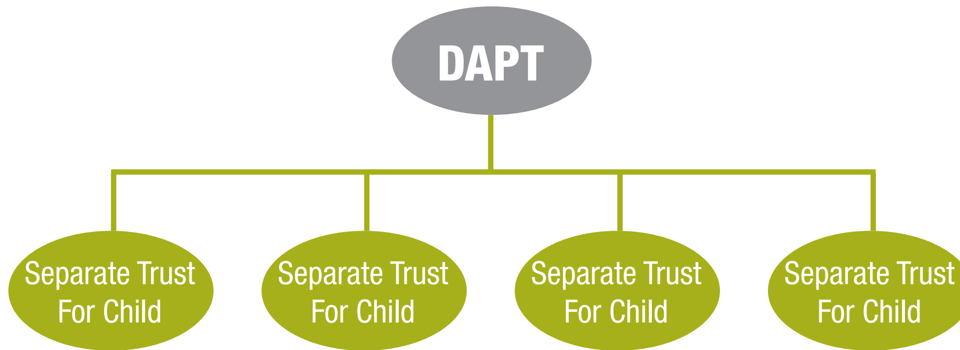
Along with the protection offered against the settlor's creditors, DAPTs can be used to protect children's inheritance against their future potential creditors. Children beneficiaries can be provided for through discretionary distributions while the trust owns the assets. This can keep creditors from these assets and protect the children from squandering assets.

DAPTs are incredibly useful and powerful tools in asset protection, but care must be taken to ensure the trusts are drafted and funded correctly. Each state has different rules pertaining to trustees, taxes, and potential terms. We will review your asset protection needs, including a close analysis of your potential risks, to determine how a DAPT can best fit your needs and then carefully incorporate a DAPT into your overall asset protection plan.



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FOREIGN ASSET PROTECTION TRUSTS:

Foreign asset protection trusts offer some of the most robust protections available against future creditors or liabilities. Like DAPTs, these are trusts created a by a settlor for the benefit of her/himself, a spouse, and children. However, these trusts use a foreign "situs" to allow the foreign jurisdiction and its laws to govern the trust and offer its protections to trust assets. For example, foreign jurisdictions can refuse to honor United States judgments or creditors. In contrast, DAPTs are subject to diverse state laws, and some states may be less inclined to honor the asset protection offered by a DAPT established in another state.

While foreign asset protection trusts offer robust asset protection, they are also subject to additional administration disclosure. For example, you may be required to file an annual Report of Foreign Bank and Financial Accounts (FBAR) per the Bank Secrecy Act. The trust will also be required to file foreign trust tax returns.

Based on your asset protection needs, we will help you decide if a foreign asset protection trust is right for your overall asset protection plan.

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529 EDUCATION PLANS:

Another tool that often goes overlooked in an asset protection plan is investment in 529 Education Plans. These plans offer excellent estate planning benefits, and in certain states, they offer robust protections for what would otherwise be considered very liquid and susceptible assets to creditor claims.

529 Education Plans are investment accounts used to save for educational expenses of a beneficiary. Each state governs the use of 529 plans and often have established official state programs to administer the 529 plans. These plans allow a donor to contribute funds that grow tax-free. Furthermore, qualified withdrawals can be made free of federal and state taxes. Qualified withdrawals generally include tuition and fees, books and other supplies or equipment required for classes, room and board, or expenses for special-needs services incurred in connection with enrollment or attendance in higher education.

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For estate planning purposes any contributions to these plans are treated as outside of the donor's estate even though the donor retains the right to make withdrawals for any reason. Most donors use the annual gift tax exemption to make contributions to 529 plans since the transfer would be subject to government tax. 529 plans offer the additional benefit of allowing donors to frontload a 529 plan using up to five years of exempt gifts per beneficiary. Therefore, a married couple could immediately fund an 529 plan with $140,000 per beneficiary without triggering gift tax. This would remove $140,000 per beneficiary from the taxable estate and allow the funds to immediately being accruing interest tax-free.

While only qualified withdrawals receive tax-free status, withdrawals can be made any time for any purpose. Non-qualified withdrawals are only subject to tax on the earnings portion of the withdrawal. Therefore, even if taxed, this allows for a tax deferral up to the withdrawal date. There is also a federal penalty for a non-qualified withdrawal, but only the earnings portion of the withdrawal is subject to the penalty. Certain non-qualified withdrawals are allowed without penalty in the event of a beneficiary's death, disability, or receipt of a scholarship.

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For asset protection purposes, certain states offer robust protections for 529 plans. Each state offers varying levels of protections, while some states offer no protection for 529 plans. On the federal level, 529 plans are generally protected in the case of bankruptcy. Except for contributions made within 2 years of filing for bankruptcy, 529 plans are excluded from the bankruptcy estate. Contributions made more than 1 year but less than 2 years prior to the bankruptcy filing are protected up to $5,000, while contributions made within 1 year of the bankruptcy filing are not protected.

Because the donor to a 529 plan retains the power to withdraw funds at any time for any reason, this plan offers a unique way to protect otherwise susceptible liquid assets. In addition to the estate and tax planning benefits, we recommend that a 529 plan be considered as a unique tool in preparing an asset protection plan.

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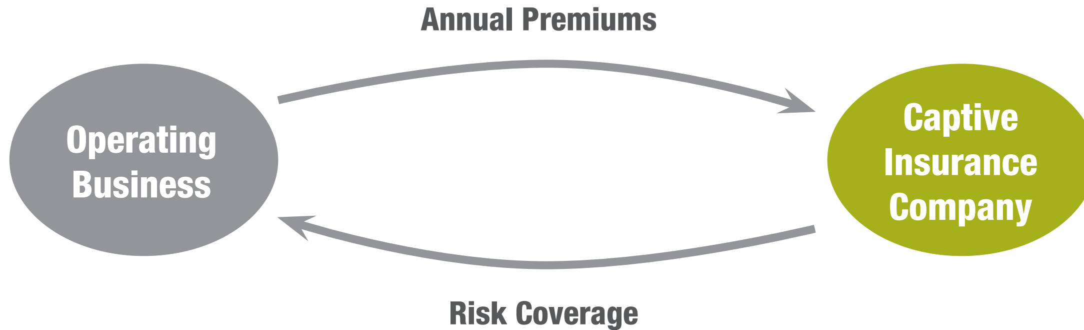
CAPTIVE INSURANCE COMPANIES:

A captive insurance company is a separate insurance company that can be set up to insure against risks that one or more operating companies could face, and which are not generally insurable on the open market. There are dozens of risks that captives can legally insure against: data breaches, loss of key employees or customers, product warranties, recalls, business interruption, copyright infringement, equipment breakdowns, regulatory changes, lawsuits, and even cyber risk. Unlike most insurance companies that are publicly owned or owned as a mutual company, the insured business owner or his/her family can also own the captive insurance company.



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SUMMARY OF RECOMMENDATIONS:

The most essential part of any asset protection plan is to get a plan in place early. Get a plan in place before there is a problem. If you wait until a claim or debt arises, then transfers of assets can be set aside as a fraudulent conveyance, so asset protection is negated.

We will help you recognize the risks you face and help create a plan that is open and effective. The first step is to identify your assets and your risks. The next step is to determine which tools are best tailored to protect your assets against those risks.

As part of any asset protection plan, we recommend that you keep in mind these essentials:

- Keep and maintain enough insurance, including malpractice and an umbrella liability policy
- Maintain proper titling. (No mater how well designed the asset protection plan may be, if assets are not properly titled, they can lose the asset protection that would otherwise be provided)
- Maximize ownership of exempt assets: 401(k)s, IRAs, life insurance, and in some states, 529 plans
- Fund retirement assets to protect non-exempt cash and defer income tax
- Use trusts and/or business entities
- Avoid fraudulent transfers
- Most importantly, plan early
- Avoid personal guarantees

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NOTES

This booklet is intended for general information and is not intended as legal advice or as a substitute for specific legal advice based upon all of your particular facts and circumstances.

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