

Asset protection

Basic principles and strategies for safeguarding your wealth

An asset protection strategy is a natural extension of any financial plan. Individuals who have built up sizable retirement savings and established equity in their homes should consider ways to protect hard-earned assets from a lawsuit, civil claims, or bankruptcy proceedings. Asset protection is often associated with high-net-worth individuals, business owners, and professionals such as doctors, who are considered at high risk of being litigation targets. But people with comparatively modest financial assets, such as a home and retirement savings, also have reason to consider instituting their own plans. Claims and lawsuits stemming from car accidents, personal injury on your property, and liabilities involving family members can place these individuals' assets at risk.

For many people, asset protection is an after-thought or not thought of at all. That is why it is important to shield your assets *before* something happens. Asset protection can help you maintain your standard of living and preserve your ability to pass assets to heirs and/or charitable organizations. Although no fail-safe plan exists, asset protection often incorporates a combination of strategies and tools. And, remember, you should always consult a qualified tax or legal advisor to determine your particular set of risks and those assets you need to protect.

In this article, we will examine different techniques that could prevent your retirement accounts and non-retirement assets, including non-liquid assets (such as your home), from falling into the hands of others. As always, you should consult your financial representative to determine what may be best for your individual needs.

Are you at risk?

Examples of those who may be at higher risk of having their assets attached by creditors:

- Business owners
- Medical professionals (especially surgeons)
- Other professionals, such as attorneys and CPAs
- High-net-worth individuals
- Board members of local charitable organizations
- Real estate investors and developers

Protecting your retirement assets

Retirement assets fall into two categories — those considered “qualified” under the Employee Retirement Income Security Act of 1974 (ERISA) and those that are not, including individual retirement accounts (IRAs). ERISA plans are given full protection from attachment by creditors, *regardless of whether the individual files for bankruptcy.** In the words of the U.S. Supreme Court (Patterson v. Shumate, 1992), retirement benefits under an employer plan “may not be assigned or alienated.” Examples of ERISA-qualified retirement plans include pensions, profit-sharing plans, and other employer-sponsored plans such as 401(k)s.

Non-ERISA accounts get limited protection

In the spring of 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act that addressed a significant disadvantage of IRAs in respect to creditor protection.

* Certain limited exceptions exist, such as claims by the Internal Revenue Service, criminal penalties, and in the context of a divorce proceeding or other matter subject to a qualified domestic relations order.

Protection for assets held in non-ERISA accounts

Under the **Bankruptcy Abuse Prevention and Consumer Protection Act**, these assets are fully protected in a bankruptcy situation:

- IRA assets attributable to rollover contributions from qualified employer plans
- Assets in the process of being rolled over into an IRA from a qualified plan (either directly or indirectly within the 60-day reinvestment window)
- SEP IRAs, SIMPLE IRAs, and 403(b)(7) accounts
- Other retirement plans not protected under ERISA, such as Individual 401(k)s

Other assets with limited protection

The law also exempts from the bankruptcy estate up to \$1 million (in the aggregate) of traditional and Roth IRA assets not attributable to rollover contributions from former employer qualified plans

The law does not provide protection outside of federal bankruptcy proceedings, e.g., civil judgments or attachments by creditors

Besides imposing more stringent rules on individuals and businesses filing for bankruptcy, the Act for the first time extended federal protection for assets held within IRAs. It is important to note that while ERISA accounts are shielded from creditors in all instances, the protection of IRAs afforded under the Bankruptcy Abuse Prevention and Consumer Protection Act exists only when the account's owner files for bankruptcy under Chapter 7 in the federal court system. Non-ERISA accounts include traditional and Roth IRAs, simplified employee pension (SEP) IRAs, and SIMPLE IRAs. (See "Protection for assets held in non-ERISA accounts" above.)

Should you roll over your retirement plan into an IRA?

Since ERISA plans such as 401(k) accounts provide unlimited protection from creditors — not just in the case of a bankruptcy proceeding — individuals who place a high priority on asset protection may want to think twice before transferring these assets to an IRA. *However, many states grant comparable protection from creditors for IRAs and other accounts such as annuities and life insurance.* Consulting a legal professional who is knowledgeable about asset protection statutes in your state can help you make an informed decision.

Protecting non-retirement assets

Many individuals have a large part of their net worth tied to non-retirement assets, such as a brokerage account, a home, or an equity stake in a business. Protecting these non-retirement assets often requires a more proactive strategy, developed long before a problem arises.

Titling or transferring assets

A simple and inexpensive method of protecting certain assets is merely to transfer the ownership of that asset. For example, one straightforward strategy for protecting a home is to transfer property ownership from the high-risk spouse (in the case of a doctor) to the other spouse who is considered low risk. There are, of course, certain complications that may arise if, for example, the marriage were to end in divorce or if the individuals reside in a community property state (e.g., California), so be sure to consult your financial representative or legal professional. It is also important to avoid a "fraudulent conveyance" — illegally transferring property to avoid payment of a pending obligation. Generally, this issue arises when a debtor transfers ownership of assets to another party in response to an unfavorable judgment or knowledge of a potential legal claim.

Alternatives for joint owners

Owning assets jointly is commonly used for both “hard” assets, such as homes, and liquid assets, such as bank accounts. Joint ownership of property can present certain challenges to an effective asset protection plan. Mainly, claims against any of the joint owners may lead to the attachment of that particular asset, thus penalizing the other joint owner(s). However, certain states allow marital property to be titled as “tenants by entirety,” which means creditors generally cannot take joint assets to pay for one spouse’s debts. Consult a legal professional familiar with state laws to determine if tenants by entirety is available within your state.

Using trusts

Trusts allow an individual to transfer ownership of assets held in his or her name to a trustee to hold in trust for the benefit of a designated beneficiary. The trusts should be irrevocable; revocable trusts such as living trusts are not effective in protecting assets from creditors. Another option is a “foreign trust,” which usually is an irrevocable trust held in and governed by the laws of a foreign jurisdiction. These trusts are generally not subject to judgments of U.S. courts. A growing number of states offer *Domestic Asset Protection Trusts* — trusts established in a U.S. state designed to shield trust assets from the creditors of the beneficiary. It is important to note that complex rules govern these types of trusts, and they may not be an effective deterrent against certain court judgments.

Options for business owners

Any business owner who may be at risk of litigation by patients, customers, or employees should consider protection from claims against the business. The idea is to structure business ownership to make it difficult or expensive for someone to access your assets. This can be accomplished by incorporating the business and creating for federal tax purposes a C corporation or an S corporation. Additional strategies include:

LLCs and LPs: Because limited liability companies (LLCs) and limited partnerships (LPs) are considered separate legal entities, assets held within them are not deemed to be “owned” by the individual. Therefore, a plaintiff seeking access to the individual’s assets will need to pursue the LLC or LP, and not the business owner

individually. A more advanced strategy using LLCs involves creating several separate LLCs for different aspects of a business, e.g., creating one LLC for business equipment and another LLC for real estate. Although more costly, this strategy creates separate legal ownerships for different business assets that may help protect them from claims on other areas of the business.

Family limited partnerships: FLPs allow parents and grandparents to create a limited partnership agreement and name themselves as general partners and their children as limited partners. An FLP lets senior family members transfer the value of their assets (such as real estate, corporate stock, and cash) to children and grandchildren, removing it from their estates for federal tax-planning purposes. Assets placed into the FLP are protected from creditors since the ownership of these assets is transferred from the individual(s) to the partnership. Creditors can target distributions of the partnership by applying to a court for a “charging order,” but this does not give them rights to the actual assets held within the partnership, only any distributions. Because FLPs are heavily scrutinized by the IRS, it is critical that they are properly structured and maintained.

College savings accounts

Programs such as 529 plans and Coverdell Education Savings Accounts (ESAs) receive federal protection from bankruptcy proceedings as follows:

- 100% of contributions made more than 720 days prior to a bankruptcy filing are excluded from the bankruptcy estate.
- Up to \$5,000 of contributions made more than one year and less than 720 days prior to the bankruptcy filing are excluded.
- Contributions made less than one year prior to the bankruptcy filing are not excluded.
- All 529 accounts having the same beneficiary are aggregated.
- All Coverdell ESAs having the same beneficiary are aggregated.
- To be excluded from the bankruptcy estate, the account beneficiary must be the debtor’s child, stepchild, grandchild, or stepgrandchild.

Similar to IRA accounts, certain states will extend additional protection for these college savings programs as well.

Captive insurance: A way to manage risk

Medical professionals and business owners face unique risks as part of their professions. By the time they reach age 55, nearly half of all physicians report having been sued.* Business owners may face risk from dealing with customers or employees. Typical strategies to manage these risks include maintaining malpractice or commercial liability insurance.

However, as the cost of insurance premiums has soared, physicians and business owners may seek alternative methods for managing their risk. One method involves establishing a captive insurance company.† The general concept is for a medical practice or business to create its own insurance company to insure all or a portion of a specific risk. For physicians, this may allow the practice to increase its deductible on its existing malpractice policy, lower coverage limits, or — over time — transition all of the risk over to the newly formed captive insurance company. The savings associated with lowering coverage on the existing malpractice policy can be used to offset the cost of funding the captive insurance company. Business owners may use captive insurance to manage a broad range of risks including employment-related claims, environmental concerns, business interruption, and breach of contract. Additional benefits include:

- Tax advantages: Premiums to fund the captive insurance company are deductible business expenses. If the annual premiums paid into the captive insurance company do not exceed \$2.3 million, the premium dollars are not considered taxable income to the company.
- Financial gain: Funds inside the captive insurance company may appreciate over time.
- Asset protection: Funds held within the captive insurance company are generally not exposed to claims from potential creditors.

Other strategies

Comprehensive home insurance coverage or malpractice insurance may be the best asset-protection tool for most people. Examples of insurance coverage include:

- Group liability, or “umbrella” coverage
- Long-term care
- Disability
- Malpractice
- Professional liabilities, sometimes referred to as “errors and omission” insurance (which provides a company protection from claims if it is held responsible for errors or a failure to perform work outlined in a contract)

A *homestead exemption* is another way to protect a primary residence from creditors’ claims. The level of protection, however, usually depends on the length of ownership. In most states, there also are caps on the amount of equity that can be protected. For states with high or unlimited caps on home equity protection (e.g., Florida and Texas), one way to maximize the protection of a primary residence from claims is to pay down the property mortgage with assets considered at risk of creditor attachment, such as cash or investment accounts. In this case, you are shifting assets (cash, investments) that may not be protected, to an asset (e.g., the home) that may receive protection from creditors due to the homestead exemption. Consult a legal professional knowledgeable about homestead-exemption statutes in your state because these rules can vary considerably.

For more information on developing an asset protection strategy that meets your needs, talk to your financial representative or legal advisor.

For more information on Putnam funds or products, call Putnam at 1-800-225-1581.

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* Source: American Medical Association (AMA), 2018.

† Establishing a captive insurance company involves its own risks and can be very complex and costly. It is critical to work with a qualified professional with experience in effectively implementing this strategy.

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