

SELF-DEFENSE HOTLINE

Shrewd Ways to Protect Your Assets From Creditors

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You have a legal right to set up your affairs in a way that protects your property from unexpected claims—as long as you're not defrauding existing creditors.

New asset protection opportunities have recently arisen but there are also a few unanswered questions to keep in mind.

domestic self-settled trusts

In a handful of states, you can put your own money in a trust for yourself and have those assets protected from creditors. In those states, you can set up a trust for yourself—a “self-settled trust”—manage the money, receive the income, have access to principal, and block creditors from laying claim to the assets in the trust.

Rhode Island and Utah have recently joined three other states—Alaska, Delaware, and Nevada—in permitting residents to set up these asset-protection trusts.

Caution: There are no court decisions addressing whether non-residents can set up a self-settled trust in one of these states to gain asset protection. It may require US Supreme Court review to ultimately settle the issue.

Bottom line: There's no downside to a nonresident seeking asset protection in one of these states—other than the cost of setting up the trust. If a court permits creditors access to funds in the trust, the nonresident is no worse off than if the trust had not been set up in the first place. And there is a possibility that a court may uphold asset protection for nonresidents. Setting up such a trust creates a significant obstacle for any creditor, giving you negotiating leverage when settling a claim.

foreign trusts

Off-shore trusts (set up in another country) are also an effective way to protect assets from creditors. Foreign courts do not have to honor US court judgments.

Caution: Several US courts have recently imposed civil contempt orders against debtors whose foreign trusts were set up after claims were made against the debtors. In such cases, the debtor is ordered to pay a US judgment with funds in the foreign trust or face an undetermined amount of jail time. Whether this trend will continue remains to be seen.

wills and living trusts

You have an opportunity to create asset protection for your family when making your estate plans. Parents often set up trusts for their children to run until the children attain a certain age. However, it may be advisable to let assets re-main in the trust indefinitely to protect against your children's future creditors or divorce claims.

Suggestion: Draft the terms of the trust to give an adult child maximum control over the funds without losing asset protection. This can be done by allowing the child to replace a trustee with someone who will cooperate with his/her wishes. The trustee can be permitted to purchase assets, such as a vacation home, which the child can use and enjoy without exposure to creditor or divorce claims. In order to avoid potential tax problems, as well as a perception that the child controls his own trust, make sure the replacement trustee is not related to or under the direct control of the child.

FLPs and FLLCs

Family limited partnerships (FLPs) and family limited liability companies (FLLCs) can be used to provide a measure of asset protection. A creditor of a limited partner cannot obtain assets from the FLP. The creditor can only get a “charging order”—a right to any distributions made to the limited partner.

Result: Assets can then remain within the family—a creditor can only receive distributions when and to the extent they are made.

Note: Where assets have been transferred to FLPs in an attempt to hinder or delay the claims of creditors, family limited partnerships do not protect assets from attachment by creditors.

529 tuition plans

All states now allow college savings through tax-advantaged accounts called 529 plans. Contribution limits and other rules for these plans vary by state. However, 529 plans may be the newest and best way to shelter funds from creditors.

About a dozen states have legislated that 529 plan funds are protected from claims against both the person contributing the funds as well as the beneficiary. Other states protect those

assets for either the contributor or the beneficiary. This protection exists even though a contributor retains control over the funds and can recoup them (albeit by paying a 10% penalty).

The limits of asset protection are high...

- Contribution limits are substantial—most plans have total (rather than annual) contribution limits, usually exceeding \$100,000. Visit www.savingforcollege.com to find out about the contribution limits for each state. Or call the state education department for any state in which you are interested.

- Contributors who set up plans for a beneficiary can avoid gift tax on contributions up to \$55,000 (\$110,000 if a contributor's spouse joins in the contribution) by aver-aging the gift over five years to take advantage of the \$11,000 annual gift tax exclusion.

- Contributors are not subject to any income limitations—wealthy individuals can make contributions. They can even set up accounts for their own benefit (sometimes referred to as “solo 529 plans”).

Assets enjoy deferral of tax on in-come until withdrawal and no tax on earnings if distributions are used for qualified education costs.

Bonus: With few exceptions, there is no bar to a nonresident setting up a 529 plan in another state, so factor in asset protection when selecting which 529 plan to use. As is the case with domestic self-settled trusts, it is not yet known whether the state law where the plan is adopted will determine whether the account is protected.

Caution: It is not clear whether funds in 529 plans would be protected if the contributor or beneficiary seeks bankruptcy protection. Federal bankruptcy legislation that has yet to be enacted may create an exemption for 529 plans.

Qualified retirement plans and IRAs

Qualified retirement plans, including 401(k) accounts, are protected from the claims of creditors under federal law.

Exception: A state court can issue a qualified domestic relations order (QDRO), directing that payments from a plan be made to a former spouse, dependent, or other person as “alternate payee.”

IRAs do not enjoy federal protection from creditor claims. However, many states extend asset protection to IRAs.

Important: Check whether the state protection applies to Roth IRAs as well. At the Moses & Singer Web site, we offer a state by state chart (see “Protecting Retirement Plans” at www.mosesinger.com/resources/protecting.shtml). **TH.**

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