Cannon Insights
A Monthly Publication by Cannon Financial Institute

## Planning Ideas—Asset Protection

The recent death of legendary Penn State football coach, Joe Paterno has brought scrutiny to a transfer he made shortly before the scandal involving his former assistant made national news. According to several reports, Paterno transferred his interest in his personal residence to a trust for the benefit of his wife. Many in the media speculated that the purpose of the transfer was to shelter the home from the reach of judgment creditors that might emerge due to the scandal.

**Here's the problem. Because the potential for liability was (or should have been) on Paterno's radar screen at the time of the transfer, the conveyance of the home would likely be considered a transfer in fraud of creditors. Although the law allows individuals considerable opportunity in protecting assets from loss, transfers that attempt to hide assets from creditors in anticipation of lawsuits that are already looming are generally ineffective.**

### Risks to Assets

Whatever the effectiveness (or lack thereof) of Mr. Paterno's planning, his sad case may present an opportunity to re-visit the importance of asset protection planning with clients. Regrettably, it often requires a notable event or personal tragedy to motivate clients to examine their own situation. In general, client wealth is exposed to a variety of risks:

- Misalignment of client intentions, their estate planning documents, and the structure of their property ownership can result in significant loss. Assets that clients assume will pass through a will or trust may pass by operation of law. Wills and trusts that have cost thousands of dollars may prove ineffectual unless property is titled appropriately.

- A natural disaster or loss of a key person can level a business or gut it of its most valuable asset.

- Federal estate taxes due within nine months of death can force liquidation of long-held wealth at a fraction of its fair market value.

- The inability of a client to manage his or her assets can come on gradually through a long-term illness such as Alzheimer's disease or arise abruptly due to a debilitating and unforeseeable injury. Unless the client has planned for this contingency prior to the onset of incapacity, his or her wishes regarding investment of assets and their ultimate disposition are at risk of being frustrated.

- A momentary distraction while driving, the negligence of an employee, or the poor judgment of an adolescent child can devastate the wealth that it may have taken a family generations to amass.

**Asset Protection Strategies**

Although not exhaustive, here is a checklist of legitimate asset protection strategies:

- **Proper titling of assets**—Advisors should review the ownership of client property to assure that manner in which property is titled reflects the client's intentions for its disposition. A classic problem involves the scenario where the client's will and trust provide an elegant plan for property disposition that maximizes the benefit of the estate tax marital deduction and exclusion, but his or her property is held jointly with right of survivorship and life insurance and retirement benefits pass directly to individually named beneficiaries. To assure the elegant estate plan is operative, assets may need to be re-titled and beneficiary designations may need to be re-aligned.

- **Purchase of Business Insurance and Key-Person Insurance**—Businesses can be protected from most natural disasters through the purchase of property insurance insuring the physical plant, equipment, and intellectual property. In addition, the business can indemnify itself against the loss of a key person by acquiring life insurance on the executive's life and naming itself beneficiary.

- **Purchase of Personal Life Insurance**—Even for wealthy clients, life insurance can assure that debts are satisfied and that family lifestyle needs are met without depleting other assets following the premature death of the family breadwinner.

- **Business Succession Planning—**A business can be protected against liquidation to pay estate taxes by developing business succession plans that select successor management and assure the tax-effective and profitable transition from one generation to the next. In addition, clients can organize their business operations as family limited partnerships and limited liability companies to protect owners' personal assets from creditors' claims, bankruptcy, and divorce.

- **Trust and Durable Power of Attorney Planning**—Individuals can protect against loss of control of assets due to incapacity through transfers to living trusts and creation of durable powers of attorney.

- **Liability Insurance**—Most risks associated with business operations can be insured through the purchase of adequate commercial general liability insurance (CGL). Specialty risks arising from the actions of officers and directors and a wide variety of employment practices can also be insured against. Furthermore, individuals can protect themselves from liability creditors by purchasing adequate amounts of personal umbrella coverage that pays in excess of home and auto insurance.

- **Investing in Exempt Assets**—Certain assets like personal residences, life insurance, and automobiles are typically exempt from creditors claims within limits. Some additional protection for the home might be available through the use of a Qualified Personal Residence Trust (QPRT). With a QPRT a grantor transfers his or her residence to an irrevocable trust, retaining the right to live in the trust for a term of years. Following expiration of the term, the home typically passes to the grantor's children. From a tax perspective, the benefits can significant. The value of the gift for gift tax purposes is not the current value of the home, but rather the discounted value of the remainder interest passing to the children, after taking into account the grantor's retained interest. Furthermore, if the grantor survives the term, the actual value of the home and all post-transfer appreciation escape inclusion in the donor's estate. From an asset protection standpoint, the grantor's judgment creditors would not be able to reach the home itself, but only the grantor's *term interest* (that is, the right to occupy the home for a term of years). In addition, the grantor's creditors would not be able to reach the children's *remainder interest*, provided the transfer in trust was not a fraudulent conveyance.

**Note, assuming the trust created by Mr. Paterno was a QPRT, the estate tax benefits would have been lost when he died during the initial term of the trust. Also, inasmuch as the transfer in trust was most likely in fraud of creditors, for the reasons previously discussed, the transfer would have been ineffective to protect even the remainder interest from creditor's claims.**

- In addition to the assets mentioned above, IRAs and qualified retirement plans also enjoy protection. Qualified retirement plan assets are totally exempt from the claims of both bankruptcy and judgment creditors. IRAs are exempt for claims of bankruptcy creditors and exempt from judgment creditors up to at least $1 million.

- **Domestic Asset Protection Trusts**—Self-settled domestic asset-protection trusts are created for the benefit of the settlor (as well as third-party beneficiaries). Until 1996, the rule adopted in every state (with limited exceptions in Colorado and Missouri) was that a trust created for the benefit of a settlor was reachable by the settlor's creditors to the maximum extent that the trustee had discretion to distribute to the settlor. In recent years, beginning in 1996, a number of states—including Tennessee, Alaska, New Hampshire, Delaware, Rhode Island, Nevada, Utah, Missouri, and South Dakota—have passed legislation changing this principle. Although there are differences among the states, the general rule is that so long as there is an independent trustee and the grantor is entitled to only discretionary distributions, trust assets are unreachable by the grantor's creditors.

- **Offshore Asset Protection Trusts**—Prior to the advent of self-settled Domestic Asset Protection Trusts, clients wishing to protect assets from claims of creditors had few choices other than to transfer assets offshore. Places like the Cook Islands and Lichtenstein were especially well known as asset protection havens. Offshore trusts allow the settlor to continue to enjoy the benefits of his or her property (similarly to domestic asset protection trusts) while at the same time offering additional barriers to collection by judgment creditors.

**Bottom Line**

There are many risks to your clients' wealth. The good news is that there are plenty of ways to protect assets from most of those risks. The key is to do it now. Don't wait until creditor claims are looming, incapacity has set in, or death has arrived.

Planning Ideas and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: www.cannonfinancial.com.

Copyright ©2012 Cannon Financial Institute - All Rights Reserved

Subscribe to Cannon Insights at http://www.cannonfinancial.com/newsletter/subscribe

**Disclaimer:** The materials and information contained herein are intended for educational purposes, to stimulate thought and discussion so as to provide the reader with useful ideas in the area of wealth management planning. These materials and information do not constitute and should not be considered to be tax, accounting, investment, or legal advice regarding the use of any particular wealth management, estate planning, or other technique, device, or suggestion, nor any of the legal, accounting, tax, or other consequences associated with them.

While the content herein is based upon information believed to be reliable, no representation or warranty is given as to its accuracy or completeness. For this reason, the program of study should not be relied upon as such. Although effort has been made to ensure the accuracy of these materials, you should verify independently all statements made in the materials before applying them to your particular fact pattern with a client. You should also determine independently the legal, investment, accounting, tax, and other consequences of using any particular device, technique, or suggestions, and before using them in your own wealth management planning or with a client or prospect. Information, concepts, and opinions provided herein are subject to change without notice.

The strategies contained within these materials may not be suitable for all clients. For many concepts discussed herein, clients are strongly urged to consult with their own advisors regarding any potential strategy and will need to strategy described herein is suitable for their particular circumstances.

Examples, provided throughout these materials, are for illustrative purposes only, and no representation is being made that a client will or is likely to achieve the results shown. The examples shown are purely fictional and are not based upon any particular client's circumstances.