

The Legal Intelligencer

ALM Properties, Inc.

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Understanding the Options for Asset Protection Planning

Wealth preservation and asset protection is a growing concern for our clients as society has become increasingly litigious.

Amy Neifeld Shkedy and Rebecca Rosenberger Smolen

2014-01-03 12:00:00 AM

Wealth preservation and asset protection is a growing concern for our clients as society has become increasingly litigious. Clients are often interested in understanding their options for preserving and protecting the wealth that they have accumulated for the long-term benefit of themselves and their loved ones, to the greatest extent possible. Some individuals and professions have greater exposure to risk and creditors than others, such as doctors, lawyers, entrepreneurs, top executives and owners of real estate, just to name a few. With proper planning, individuals can mitigate some of the potential risk of having their assets depleted at the hands of a creditor.

There are numerous asset protection strategies available to protect assets from the bite of creditors, while still preserving access, to some degree, for a client. However, proper timing for implementing such strategies is of the utmost importance. Asset protection planning should be pursued when there are no existing or foreseeable liabilities or claims (or at least when there are significant surplus assets beyond those necessary to satisfy any such liabilities or claims). Otherwise, any attempt to transfer assets could be considered a fraudulent transfer with the intent to hinder, delay or defraud creditors (in such situations, statutory remedies would be available to creditors under the Pennsylvania Uniform Fraudulent Transfer Act, 12 Pa.C.S.A. §5101 et seq.).

Many clients have asset protection techniques in place, without even knowing it. For others, there is always more that can be done to accomplish their goal. Below is an overview of some typical asset protection techniques, although they are by no means exhaustive.

Retirement Plans

Assets in qualified retirement plans, which are governed by the provisions of the federal Employee Retirement Income Security Act of 1974 (ERISA), are protected from the claims of creditors in two ways: (1) they are excluded from a debtor's bankruptcy estate, and (2) they are exempt under federal law with regard to state court proceedings under the so-called "spendthrift provisions" of ERISA and the doctrine of federal law preemption with respect to claims of creditors under state law. Qualified retirement plans include such plans as 401(k) plans, defined-benefit pension plans and profit-sharing plans. IRAs composed of qualified rollovers from qualified retirement plans are treated the same way as qualified plan benefits for bankruptcy purposes.

In a nonbankruptcy setting, IRAs do not generally have any creditor protection under applicable federal law. Accordingly, the extent to which IRAs are protected from creditors' claims (outside of a bankruptcy proceeding) is determined by state law. Pennsylvania law protects contributions to an IRA up to \$15,000 per year as well as any rollover contribution from an ERISA-qualified retirement plan. In addition, under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, there is an exemption of \$1 million (adjusted for inflation) for IRA assets (which is helpful to the extent an IRA is funded with contributions other than rollovers from qualified plans).

At the moment it is not clear whether or not inherited IRAs may be exempt from creditors' claims to the same extent as self-funded IRAs. Courts around the country have been rendering conflicting decisions on this issue. More clarity

should be available within the next year because the U.S. Supreme Court has recently granted certiorari to a case involving this issue. However, for future inherited IRAs, protection may be available by structuring the inheritance so it passes to a trust for the benefit of a beneficiary, instead of outright to the beneficiary.

Tenancy By The Entireties and Homestead Protection

Pennsylvania is one of the states that allows for a special kind of ownership for property possessed by spouses, known as "tenancy by the entireties." When spouses together acquire a residence (or other real or personal property), unless otherwise specified, each is deemed to receive a 100 percent undivided interest in the property, which cannot be severed or encumbered by the acts of only one of the spouses. When it comes to creditors pursuing a claim under state law, the debts and judgments against one spouse cannot affect property held by the entireties. However, of course, all bets are off if the nondebtor spouse predeceases the debtor spouse, in which case the property passes to the debtor spouse by operation of law and a judgment creditor may then execute upon the property. Obviously, the best scenario would be to have the spouse who was less likely to be a debtor be the sole original owner of the property. Hindsight is 20/20.

There is no homestead exemption from creditors' claims offered in Pennsylvania. In some other jurisdictions, such as Florida, such an exemption is available for a homestead. When such an exemption is available, it may make sense for a client to increase equity in the homestead to the maximum extent possible.

Life Insurance

Generally, under Pennsylvania law, life insurance policies will be protected from claims of creditors. Here are some key points as it relates to protection of life insurance policies:

- Both the death benefit and cash value of a life insurance policy payable to the insured debtor's spouse, children or dependent relatives are exempt from attachment or execution on a judgment.
- Proceeds from a life policy are exempt from creditor claims if the policy or supplemental agreement provides that the proceeds and income from the policy are not assignable (a "spendthrift-type" provision).
- Insurance paid to an inter vivos trust should retain its exemption if the beneficiaries are the family members of the insured or if the trust has a spendthrift clause.
- Group life insurance is also exempt from the insured's creditors' claims.
- Under 20 PA C.S.A. Section 6108, a death benefit payable to one's estate is subject to the decedent's creditors' claims; however, death proceeds paid to a testamentary trust are not subject to the estate's creditors. Thus, care should be taken when completing beneficiary designation forms so that life insurance proceeds will not inadvertently be exposed to creditors' claims.

529 Plans

About half of the states provide some sort of creditor protection for account balances held by 529 plans (aka education savings accounts). Pennsylvania provides protection for the owner and the beneficiary of a 529 plan. It is not clear whether any creditor protection would be available to a Pennsylvania resident who holds a 529 plan in a different state (and residents of other states face the same issue). Thus, the safest approach, when it comes to asset protection, is to establish a 529 plan in the state in which the participant resides.

Trusts

A trust, whether created during one's lifetime or at death, can be an effective way to shield assets from a trust beneficiary's creditors. In many situations, it may be advisable to gift or leave money to one's spouse and/or children in a trust, rather than outright, in order to protect the assets from that beneficiary's potential future creditors (which, these days, often include a divorcing spouse).

Asset protection is generally not available, however, if someone creates a trust for his or her own benefit—a so-called "self-settled trust." A potential exception may be available if the trust is properly established in a state that has enacted "asset protection trust" laws, which specifically grant asset protection from a settlor's creditors for self-settled trusts (such states include Alaska, Delaware, Nevada and South Dakota). Historically, this type of protection was only available through the use of foreign-asset protection trusts, but, with increasing popularity and concern for creditor protection, state statutes authorizing domestic asset protection trusts have emerged to satisfy these objectives.

It may be possible for residents of states that have not enacted such legislation (such as Pennsylvania residents) to take advantage of these asset protection trusts by choosing a qualified trustee that is located in the governing-law state

and/or fulfilling such other statutory requirements provided by the asset protection trust statute of the selected state. There are many trust companies located in states with asset protection trust laws that are available to serve in the role of a qualified trustee for this purpose, however, clients must be willing to foot the bill for this service (typically at a minimum of \$10,000 per year). It is important to be mindful that it has not yet been conclusively established that these asset protection trusts would, in fact, provide the desired creditor protection for nonresidents after the application of the full faith and credit clause of the U.S. Constitution. However, it has been demonstrated that, at the very least, under current law, they can provide an impediment to creditors pursuing their claims and thus create the opportunity for potential leverage in negotiating a favorable settlement.

Entity Formation

Transferring assets (ranging from marketable securities to real estate) to an entity, such as a family limited partnership (FLP), is a technique that can provide asset protection. Many states give these entities "charging order" protection, whereby creditors can only reach a distribution made from the entity to an individual owner. If structured properly, these entities can have numerous other advantages, beyond asset protection, such as providing discounts for gift and estate tax valuation purposes, providing a vehicle for the consolidation and effective management and control of family assets and keeping family assets within the family. Also, perhaps most importantly, a liability arising with respect to the assets held by the entity should be limited to the entity's assets, thus insulating other assets of the owner of the entity from any such liability.

Amy Neifeld Shkedy and Rebecca Rosenberger Smolen are co-founders of the boutique firm Bala Law Group (www.balalaw.com) and concentrate their practices in trust and estate planning and administration.

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