ASSET PROTECTION

The purpose of this article is to explain some principles of asset protection and how one can help protect his or her estate.

I. ASSET PROTECTION DEFINED

"Asset protection" is an advanced form of estate planning. The purpose of asset protection and estate planning is to: (1) protect the assets and property that you have accumulated; and (2) shelter your assets and income from contingent liabilities.

Your assets and their proceeds can be protected to provide for your family, to provide for your children's college education, reduce income and estate tax burdens, provide sufficient moneys for retirement, and to plan for, and minimize, the hardships in the event of severe illness or disability.

II. GOOD INTENTIONS ALONE ARE NOT SUFFICIENT TO PRESERVE YOUR ESTATE

In order to protect your hard earned assets, you must plan ahead for possible contingencies. Failure to create an estate plan could be subject you or your estate to significant losses or taxes. Good intentions alone cannot substitute for professional estate planning.

The law allows you to protect your family and assets pursuant to a properly adopted estate plan. You must however execute the proper documents before the occurrence of a financial derailment otherwise your actions could be considered by a court to be a fraudulent transfer. Additionally, the investments and decisions made in asset and estate planning must be shown to have a viable, worthwhile purchase.

For instance, if you are sued tomorrow (before enacting an estate plan) and then took all of your cash assets and paid off your home to take advantage of the homestead exemption, a creditor could argue that you have violated the Fraudulent Transfers Act and defrauded your creditors.

Paying off your home is a legitimate asset and estate planning protection tool. It is supported most frequently on the reason that the motive for paying off the homestead was to take care of a spouse and family, reduce living expenses, and reduce payment of interest. This must be done before, not after the occurrence of a contingency.

III. SOME COMMON PITFALLS:

If you or your spouse has not filed income tax returns, or has income tax levies against him or her, then the other spouse (including one from a new marriage) is now liable for the tax deficiency. Your (community) property is at risk in that situation.

If you are named on a corporation's Board of Directors, or serve as an Officer of a corporation, you may find yourself liable for the corporation's withholding 941 tax deposits which have not been made.

Transfers of business property or stock can back-fire if not done properly. An owner of a well-established business, for estate planning purposes, transferred stock in his business to his children. Unfortunately, one of the children subsequently became divorced, and all of the stock was awarded to the other party in the divorce. That interest in the business is now owned by strangers.

IV. FRAUDULENT TRANSFERS

The Texas Uniform Transfers Act is designed to protect creditors from fraudulent transfers when debtors seek to hide their assets, hinder, or defraud a creditor.

The Act prevents hindering, delaying or transferring properties if a court determines that the purpose of a transfer was to defraud a creditor. The Act has a four year statute of limitations time period from when the transfer was made, or one year statute of limitations time period after a transfer was, or could have been, recently discovered.

The Act protects creditors whose claims arise within a reasonable time before, or after, the transfer was made. Unfortunately, the language of the Act makes it very difficult to ascertain what transfers will be considered a violation of the law, and which ones will not be.

It may be up to a jury to have each individual transaction determined. In determining the intent of whether a person intended to defraud creditors, the following evidence may be considered:

1). If the transfer was made to an insider, such as another member of the family,

2). If the debtor retained possession or control of the property transferred, even after the transfer was made,

3). If the transfer was concealed or removed from the jurisdiction of the Texas courts,

4). If the transfer was made after the debtor was sued or threatened with a lawsuit, and if the transfer was substantially all of the debtor's assets, and

5). If the debtor is now insolvent as a result of the transfer.

The Texas Fraudulent Transfers Act does not look at the solvency of the financial condition of the transferor, but rather looks at the intent of the person making the transfer at the time the transfer was made as the basis for determining whether or not the conveyance was fraudulent.

The statute provides that a transfer is deemed fraudulent if a debtor makes a transfer without receiving a reasonably equivalent value for the exchange, and the debtor was:

1). engaged in, or was about to be engaged in, a business or transaction for which his remaining assets were unreasonably small, or

2). intended to incur or believed to have incurred debts beyond his ability to pay the same.

A transfer is also fraudulent if a creditor has a pre-existing claim and the debtor transfers property without receiving a reasonably equivalent consideration for the transfer, and the debtor was insolvent at the time, or became insolvent because of the transfer.

In addition to the Texas Fraudulent Transfers Act, Section 528 of the United States Bankruptcy Code prohibits fraudulent transfers. Transfers made by a debtor within one year before the date of filing a bankruptcy petition may be overturned if the transfers are made with actual intent to hinder, delay or defraud any creditor, or made for less than fair market value.

VI. PROTECTING YOUR RETIREMENT PLANS AND INSURANCE POLICIES

You should protect your retirement and insurance benefits. These two types of property are often the most valuable assets in your estate. Accordingly creditors have sought to obtain the cash value of those assets. The exact nature of these type benefits will determine whether it is exempt from claims of creditors, however, the Texas Property Code Section 42.0021 exempts qualified retirement plan benefits and insurance benefits from seizure by creditors. This includes but is not limited to, the cash value of the insurance policy, as well as the death benefit awards or proceeds from the insurance. Therefore, insurance enjoys the same protection that the homestead has enjoyed. Accordingly, qualified permanent life insurance cash values, death benefits and annuity values are protected and may be used as asset protection vehicles.

Section 541 of the Bankruptcy Code defines property of the bankruptcy estate to include all legal and equitable interests of the debtor in property as of the date that the bankruptcy is filed. This is subject to the exemptions which may be claimed by the debtor. This is also subject to a restriction on the transfer of the interest that a debtor had in a trust. Therefore, based on current law, under Section 541, a debtor's interest in a valid, spendthrift trust is not property of the bankruptcy estate, and creditors may not seize the debtor's interest in a trust with a valid spendthrift provision.

The retirement plan at its creation must receive a determination letter from the Internal Revenue Service indicating that the plan is qualified. Unless the plan is audited by the IRS, it will continue to be a qualified plan even though it may have been used for activities that might result in disqualification. And remember, creditors still may be able to attach pension or insurance proceeds if a debtor has violated the Texas Uniform Fraudulent Transfers Act.

V. WHAT TYPES OF INSURANCE SHOULD I HAVE TO PROTECT ME AGAINST LAWSUITS?

A. You should consider four types of insurance:

1). Homeowners Insurance: Your homeowner's policy is absolutely essential: (a) to protect the value of your home, and, (b) to provide liability coverage for contingencies that may happen at your homestead. We recommend that you talk to your insurance broker and consider getting the largest liability protection amount that is available. Generally, the cost is quite reasonable.

2). Automobile Insurance: Although Texas law requires drivers to have auto insurance, many people do not have insurance or only have the lowest limits of liability. You should consider discussing your coverage with your agent, and consider purchasing the maximum coverage that is allowed. You should obtain the highest limits that are available for the following types of coverage: (a) personal injury protection; (b) uninsured coverage, and (c) underinsured coverage. The cost is quite reasonable in exchange for the protection that the above coverage offers.

3). Umbrella Liability: This is an important insurance product that you should have since your homeowner's, automobile and boat or recreational vehicle policies have limits in the event that you are liable for a judgment that is larger than the policy limits, you would be liable to pay the difference. Umbrella insurance covers that liability. It expands the total amount of liability coverage and dollar amount for usually a relatively small premium. It may also increase liability coverage to other areas that are not covered by traditional home, auto or boat policies. For example, liable and slander may be covered.

4). Negligence/Malpractice/Errors and Omissions Insurance: Most professional business people are aware of this type of insurance and have had the same for quite some time. This type of insurance has become increasingly expensive in recent years, and due to the large amount of verdicts that have been assessed against professionals, one can not continue to rely on malpractice insurance to protect them from all of the contingencies that may arise in their business.

One big mistake that people make is relying too heavily on insurance, not realizing that the company may not cover you in a given situation, or the company may go out of business. Accordingly, one needs to look at other ways to protect assets.

VI. TYPES OF PROPERTY THAT IS EXEMPT FROM SEIZURE BY GENERAL CREDITORS AND THE TEXAS HOMESTEAD EXEMPTION

A. Definitions Of Property Categories

For the purpose of this discussion, property is categorized as follows:

1). *Personal Property and Real Property*. Real property consists of land, buildings, real estate, oil and gas interests, easements and non personal property. Personal property consists of property that is not real property. Examples include: furniture, money, tools and various other property rights including, but not limited to, intellectual property rights, patents, copy rights and other rights.

2). *Exempt and Non-exempt Property*. Exempt property is property that a general creditor cannot seize or take to satisfy a judgment (unless that property has a valid lien placed on it to secure a

debt typically a purchase money debt). Non-exempt property is property which a creditor may seize to satisfy a judgment or a debt.

B. Exempt Real Property In Texas: The Texas Homestead Exemption

The following types of property are included under the term *exempt property* in Texas:

1). *A homestead:*

a. An urban homestead consists of one or more lots that do not exceed more than 1 acre of land together with any improvements on the land regardless of whether it is a family homestead or a single adult.

b. A rural homestead consists of, for a family, not more than 200 acres which may be in one or more parcel with improvements thereon and 100 acres for a single adult.

c. A homestead and one or more lots used for the place burial of the dead are exempt of seizure for the claims of creditors except for encumbrances or liens properly fixed on the homestead property.

Remember though, encumbrances or liens may be attached on homestead property for the purchase of the property (purchase money), taxes on the property or work and material used in constructing improvements on the property (materialmen & mechanic's liens). Also be aware that the temporary renting of a home does not change its homestead character if the homestead claimant has not acquired another homestead. Further, if the homestead claimant is married the homestead cannot be abandoned without the consent of the spouse.

C. Exempt Personal Property In Texas

Personal properties of various categories are considered exempt up to a total fair market value of $60,000 per family or $30,000 per single adult who is not part of a family. The following personal property is exempt from garnishment, attachment, execution or other seizure as follows: $60,000 (or $30,000 for a single person) exclusive of the amount of any liens, security interests or other charges encumbering the property. If the personal property exceeds the statutory exemption amount, the head of the family or the person entitled to the exemption may designate which property they desire to have the exempt status and which property should be non-exempt.

The property that is exempt includes the following:

1). Current wages for personal services & court ordered child support payments;

2). Professional prescribed health aids of a debtor or a dependent of a debtor (this section does not prevent seizure by a secured creditor with a contractual landlords lien for the security and the property to be seized);

3). Unpaid commissions for personal services, not exceed 25% of the aggregate limitations described above;

4). Home furnishings, family heirlooms, provisions for consumption;

5). Farming or ranching vehicles and implements;

6). Tools & miscellaneous equipment;

7). Books;

8). Apparatus including boats and motor vehicles used in a trade or profession;

9). Wearing apparel & jewelry not to exceed 25% of the aggregate limitations (the $60,000 or $30,000 amounts);

10). Two firearms;

11). Athletic and sporting equipment including bicycles, a two wheeled, three wheeled or four wheeled motor vehicle for each member of a family or single adult who have a drivers license or does not hold a drivers license but relies on another person to operate the vehicle for the benefit of the non licensed person;

12). The following animals and foliage on hand for their consumption: a. two horses, mules, donkeys and a saddle, blanket and saddle for each; b. twelve head of cattle; c. sixty head of other types of livestock; d. 120 cows; e. household pets;

13). The present value of any life insurance policy to the extent that a member of the family of the insured or dependent, a single insured adult claiming the exemption as a beneficiary of the policy.

14). Retirement plans: In addition to the exemptions described above, a person's right to the assets held or to receive payment, whether vested or not, under any:

a. stock, bonus, pension, profit sharing or similar plan,

b. retirement plans for self employed individuals or any annuity or similar contract purchased with assets distributed from that type of plan and under any retirement annuity or account described by Section 403 (of the Internal Revenue Code 1986) and under any individual retirement account or any individual retirement annuity including a simplified employee pension plan is also exempt from attachment from any execution and seizure for the satisfaction of debts unless the plan, contract or account does not qualify under the applicable provisions of the Internal Revenue Code.

D. Designation Of Your Homestead

For urban properties, the head of the household may voluntarily designate not more than one acre of the property as the homestead. If a rural homestead is part of 4 or more parcels containing a total of more than 200 acres, the head of the family if married, may voluntarily designate not more than 200 acres of property as the homestead.

To designate the property as a homestead the person must make the designation in a properly completed instrument that is signed and acknowledged or approved in a manner required for the recording instruments, *i.e.* notarized. A person must file the designation with the county clerk of the county in which all or part of the property is located.

E. Designation Of A Homestead After A Judgment Has Been Obtained

If a judgment has been obtained against you, the creditor may take steps to collect or enforce the judgment. Once a judgment has been obtained, the creditor can file notice of the judgment thirty days after the judgment becomes final. This filing is called an " Abstract of Judgment".

If the creditor has requested an execution of judgment to be issued against you (if you are a judgment debtor) and if you own a homestead you must protect your homestead by filing a Voluntary Designation of your homestead under Section 41.005 of the Texas Property Code.

If you have not designated your homestead, the judgment creditor may give you, the judgment debtor, notice to vacate your homestead as defined in Section 41.002 of the Texas Property Code. The notice shall state that if the judgment debtor fails to designate the homestead within the time allowed by Section 41.002 of the Texas Property Code, the court will appoint a commissioner to make the designation at the expense of the judgment debtor.

At any time before 10:00 am on the Monday next after the expiration of 20 days after the date of the service of the notice to designate (the general time period allowed for answering lawsuits), the judgment debtor must designate the homestead as defined in Section 21.002 Texas Property Code by filing a written designation, signed by the debtor in front of the justice or the clerk of the court from which the writ of execution is issued, together with the legal description or area designated as your homestead.

F. Sale Of The Excess Of The Homestead

An constable or officer may sell the part of your property which exceeds the homestead exemption, (if your property exceeds the statutory allowance). The sale can be conducted pursuant to the holding an execution (a sale of your property).

G. Liability For Community Debts

Debts which are incurred during a marriage are presumed to be on community credit and are presumed to be community obligations unless it is shown that the creditor agreed to look solely to the separate estate of the person who took out the loan. Therefore, the community interest may be subject to satisfaction of the debt.

H. Garnishment Of Bank Account Proceeds To Satisfy A Judgment

Garnishment involves a legal procedure whereby a person who is owed money, typically in the form of a judgment, is entitled to seize and collect assets that are owed to the judgment debtor. Garnishment can occur on property owned directly by the debtor or property held by a third person that is owned by the judgment debtor. For instance, if a person, as a defendant in a lawsuit, incurs a judgment for $100,000 and if that judgment debtor has $50,000 in a bank account, a creditor may be able to garnish the $50,000 in the bank account to partially satisfy the judgment debt.

Bank deposits are the most commonly garnished debt. Bank deposits can be reached regardless of the account name if the funds are owed to the judgment debtor. Of coarse, community funds likewise can be garnished. Contents of a safety deposit box can also be garnished. The bank can be sued in a garnishment action to obtain the contents of the safety deposit box.

I. Garnishment Of Stock Certificates or Promissory Notes To Satisfy A Judgment

Judgment creditors can obtain your stock through the garnishment process. Creditors can seize certificates held by your or held for you by a third party, i. e. a mutual fund, stock broker, etc. Monies that are owed to a judgment debtor in the form of a promissory note can be garnished.

J. Trust Funds In Which The Debtor Is The Beneficiary

Monies from a trust fund can be subject to payment of the beneficiary's debts if the trust fund fails to contain what is known as a "spend thrift clause". A spend thrift clause prohibits the beneficiary's creditor from attaching the trust and taking the moneys earmarked for the beneficiary out of the trust and then payment of the same to the creditor. Even if a spend thrift clause is included in a trust, once from the trust are paid to the debtor, they can then be garnished.

VII. WHAT ARE SOME OF THE CONSEQUENCES OF DYING WITHOUT A WILL IN TEXAS?

The State bar of Texas and the American Bar Association, as well as most state bars, recommend that every adult person have a will. If you die without a will, you are considered to have died intestate. Consequently, your property will be distributed pursuant to the state's probates code provisions relating to intestacy rather than at your direction.

A. Hardships Imposed By Dying Intestate (Without A Will)

1). Increased Cost. Perhaps one of the most important reasons for having a will is to streamline and reduce the probate process and to simplify the winding up one's financial affairs. Intestacy can create hardships for your family and can significantly increase the cost of closing out your financial affairs. It may cost your heirs significantly more money to have your estate administered if you have not executed a valid will which appoints an Independent Executor to serve without the requirement of posting a bond.

2). Loss of an Independent Executor. If you had a will and the will provided for the appointment of an independent executor to serve without bond, the cost of probating your will and winding up and administering you estate would have been relatively inexpensive compared to what it can cost if the court must appoint an executor to administer the estate. The court appointed administrator may have to post a bond and have his or her actions approved by the probate court prior to winding the affairs of your estate.

3). The Texas Probate Code allows a person to name an independent executor in his or her will. The independent executor can very quickly and inexpensively wind up your affairs, pay your bills, sell unneeded assets, and distribute your property according to the terms of your will. One aspect of this procedure that makes it so quick and cheap, is that the executor does not have to obtain court approval for the above actions.

The executor is only required to file the will for probate, attend the probate hearing, take the oath to serve as the executor, obtain letters of testamentary (to act for the estate) and then file an inventory and an appraisement that lists the property owned by the deceased. The executor is entitled to pay the debts and distribute the assets of the estate without court supervision. This saves a lot of time and a lot of attorney's fees!

This is a very cost efficient way of handling probate since your estate only pays for the attorney's time in getting the will approved by the probate court. Thereafter your estate does not have to pay the attorney to obtain court approval every time the executor wants to pay bills, sell property or distribute the assets to the beneficiaries. You may lose that right if you die without a will because the probate court may supervise the entire distribution of the estate. The estate can then be eaten up by attorneys fees from court appointed attorneys and receivers as opposed to the being paid directly to your heirs and beneficiaries.

The problem in Texas without a will is that you lose your free agency to decide how you want your property and assets distributed and plan for your family. You now defer to the state's intestacy laws, which may or may not be acceptable to you. You also increase the probate process and cost. The moral of the story is that every adult should have a will.

VIII. LIVING TRUSTS AVOIDING PROBATE AND PROTECTING ASSETS

A. What Is A Trust?

A trust is a legal arrangement whereby property may be given by a donor or trustor to a trust for the use and benefit of another person known as the beneficiary.

Trusts are useful for protecting and preserving property and in some instances in reducing tax liability. Trusts may be created and effective while the donor is alive or may take effect at the donor's death. The person who controls the trust property is known as the trustee. The trustee acts for in behalf of the beneficiary named in the trust document.

A common trust, known as the revocable living trust, is used frequently by estate planners. It has some advantages and some disadvantages. A living trust is created while the donor is alive. A

trust which is typically created in a donor's will and becomes effective upon the donor's death is known as a testamentary trust.

The donor can also be both a beneficiary and the trustee. This means that a donor can have full control over all of the assets placed into the trust. Note there may be some tax considerations which would suggest some third person be named as the trustee, however you should discuss tax consequences of trust and estate planning with a qualified tax advisor such as a CPA (Certified Public Accountant) or tax / estate planning attorney.

B. Living Trusts

A living trust is therefore a trust which is created during the donor's lifetime whereby property is placed into the trust for the use and benefit of the parties named in the trust agreement. The donor can be one of the beneficiaries named in the trust. To create a trust the donor transfers ownership of the assets that he or she would like to place in the trust from himself as an individual to a trustee, who will serve as trustee of the trust.

Trusts should always be memorialized with a written document. Once the donor transfers money from himself to the trust, the assets are no longer in his or her personal name, this gives rise to the ability of a trust to reduce or avoid probate when a person dies. If all of a person's assets are in the name of a trust when a donor dies then obviously there is nothing to probate.

In a living will the donor transfers his or her property to the trust, then the donor names a trustee. If the donor remains as trustee, then he or she maintains full control over all his or her assets which are contained in the trust. The donor can manage & use the property, including buying, selling, leasing, giving or spending as he or she sees fit.

C. What Are Some Advantages Of Having A Living Trust?

1). Avoiding Probate. The property placed in the living trust does not have to be probated. Those assets would be given directly to the beneficiaries pursuant to the terms of the trust agreement thus avoiding the expense and delay of probating a will.

Texas, as well as some other states, have a simplified and an inexpensive probate system, therefore a living trust may not be as desirable in Texas as compared to some other states. Since Texas has an efficient probate system, many Texas attorneys still prefer the use of a conventional will and having the will probated instead of setting up a living trust. One reason for this is that in Texas a person is allowed to name an independent executor who can probate the will and act without posting a bond and act without direct court supervision concerning the administration of the estate. The independent administration-without bond therefore reduces the cost of probate and simplifies the process.

Avoiding probate costs & expense can become a significant expense if the donor owns real property in more than one state. The use of a living trust can circumvent the need for probate proceedings in other states where property is owned. A probate in Texas generally will not transfer title to real estate in other states to the heirs in a state other than Texas, therefore an

ancillary or another probate is generally required to transfer property to the named beneficiaries when the property is owned in more than one state. Consequently, in this situation, a living trust could avoid some probate expense.

2) More Flexibility With A Living Trust. Another benefit of a living trust is its flexibility. The donor can select himself or any other person to be the trustee. The trustee then has full control over the assets in the trust as dictated by the terms of the trust. If the donor is the trustee he or she can change or alter the terms of the trust at anytime.

The donor can revoke or cancel the trust at anytime if he or she is the trustee. When the donor dies, the living trust, which actually is a revocable living trust states how and when the donor's property shall be distributed. Assets can be distributed to the beneficiaries in the time periods, amounts, and manner as stated in the trust document. For instance, the donor can specify that a certain amount of money should be used to finance children's or grandchildren's education. Likewise the donor could reserve or specify that from the estate could be used for payment of medical expenses or special needs of his or her beneficiaries such as a disabled or handicapped children.

3) Privacy. The living trust document is generally not filed with the probate court, therefore its terms are not open for inspection by the public. On the other hand a will must be filed with the probate court to be admitted to probate. It then becomes a public document. The will may then be inspected and reviewed as any other public document. Therefore, if you are interested in complete privacy, a trust may be preferable to a will.

4) Litigation and Contest. Law books are full of suits where unhappy heirs have sought to contest deceased person's will. A will can be contested if it can be proved that the person writing the will, the testator, was unduly influenced to make gifts to one person or another or that some one in a position of trust benefited in the will by unduly influencing the testator. The unhappy relatives can argue that some other party inserted their desires in the testator's will due to their position of trust.

IX. HOW TO OWN PROPERTY

Property should be owned so that the most protection allowed by law is afforded. What we mean by this is that you should analyze the source of income and the possible consequences or contingencies that may be tied to the receipt and production of said income. Today, most people own property in Joint Tenancy. Property held jointly with rights of survivorship may provide some asset protection, but at the same time, creates liabilities. The reason being that if two parties have equal right to control or own property, in the event one party suffers a liability, all of said property may be taken by that party's creditors, and thereby deprive the other owner from his or her ownership in that property.

Likewise, one should operate his or her business so that they receive the maximum protection allowed. One partner can easily be liable for the wrongful conduct of another partner. Accordingly, there are many different entities that afford protection depending on ones needs. For example, an individual may wish to utilize a Family Limited Partnership or a Spendthrift

Trust to protect individual assets. Whereas a business may wish to operate as a Limited Liability Company or Corporation to shelter its owners from liability. What works best for each person or business depends on circumstances specific to that individual or business.

CONCLUSION

Asset protection is available, however you must carefully analyze your income and assets. Then determine the best entity to hold the assets while still deriving the income. Thereafter you must follow all corporate or partnership rules to enjoy the protection that the law affords, failure to follow the tax or state rules can void the protection you would have otherwise received.

We hope this article illustrates some of the reasons why you should have your business and personal affairs reviewed or managed by competent tax, financial and legal professionals. Of coarse if we can answer any questions or be of any help please let us know by email, phone, or simply filling out the inquiry form on this web site.

Article Adapted From Westlaw