

Guarding Your Wealth Estate Planning

Individuals often seek to protect their assets against claims of negligence or recklessness, claims of professional malpractice, shareholder derivative lawsuits against corporate officers and directors, or a spouse in a divorce. In many situations, individuals may not have recourse against lawful creditors' claims, but there are proactive steps individuals may want to consider discussing with their legal and tax advisors in order to help protect their assets, particularly in situations where there exists no current creditor's claim and the individual is not aware of any basis for the assertion of a claim.

Legal Background

Any asset protection plan should be fully discussed and vetted with appropriate legal counsel. To be effective, asset protection planning must be undertaken before the occurrence of any event that could give rise to potential liability. Asset protection planning can vary significantly from state to state. The boundaries of asset protection planning are set, in part, by fraudulent conveyance and bankruptcy laws. A "fraudulent conveyance" is generally an inappropriate attempt to avoid the payment of a debt or liability by transferring assets beyond the reach of creditors. Creditors can generally set aside a fraudulent conveyance to the extent necessary to satisfy their claims. Bankruptcy may help a person by discharging some debt, but not all, or creating a plan to repay debts. Bankruptcy may be voluntary when a debtor seeks protection from their creditors, or it may be involuntary when creditors seek relief from the debtor's assets. Generally, individuals seek to avoid bankruptcy due to its severe consequences, however a full discussion of bankruptcy is outside the scope of this paper. It is mentioned here only for the purpose

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of identifying that federal bankruptcy laws set many of the boundaries for asset protection. While every client's situation is unique, below are some basic asset protection strategies.

Liability Insurance

There are two main types of insurance: life insurance and liability insurance. Liability insurance, sometimes referred to as "third-party insurance", provides protection against claims resulting from injuries or damage to other people or property. Liability insurance policies may cover legal costs and all or part of an insured individual's financial responsibility if the insured individual is found legally liable. The liability insurance serves as a hedge against valid claims. A few examples of liability insurance include automobile insurance, homeowner's insurance, general business liability insurance (i.e., a customer, vendor, employee suffers injuries), and professional liability insurance (for lawyers, doctors, etc.).

Transferring Property to a New Owner

Another strategy for protecting assets from creditors is to transfer the assets to a new owner. If an individual transfers property to a new owner, either by gift or by sale, the individual (or "transferor") will no longer own the property, and creditors generally cannot reach property transferred to a new owner before there exists any basis for a claim against the transferor (please note, if the transfer is a gift, there may be additional reporting and/or payment obligations under the US federal gift tax laws). Transfers can also be made to new owners in trust. A properly drafted trust for the benefit of someone other than the transferor may be an effective strategy to transfer assets out of the reach of the donor's creditors (and possibly the creditors of the beneficiary). However, it should be noted that in most states, in order to protect creditors' rights, where the transferor retains an interest in a trust as a beneficiary or control over the trust assets, the trust is usually not effective to protect the assets from the transferor's creditors. Thus, whether such a strategy can be used and whether it may be effective is a determination made by legal counsel because any such strategy may be subject to potential challenges by a creditor and there is no guarantee that such strategy would withstand the challenge.

Changing the Title of Property

Similar to transferring property to a new owner, changing the title of property to joint ownership can sometimes offer protection against creditors. It should be noted that such a change in ownership may be treated as a gift and may trigger reporting and/or payment obligations under the current US federal gift tax laws. With respect to property held jointly with rights of

survivorship ("JTWROS"), any joint owner can unilaterally sever their interest from that of the other joint owner(s) during their life, but if the interest is not severed, upon a joint owner's death their joint tenancy interest is transferred to the surviving joint owner(s) outside of probate and outside the reach of creditors. However, a creditor of any joint owner may be able to reach a joint tenant's interest in the property during their life. Another option in some states is a "tenancy by the entirety," which is a JTWROS between spouses. A tenancy by the entirety prevents the creditor of only one spouse from reaching the property so long as the spouses remain married to one another (or so long as the debtor spouse predeceases the other spouse). In contrast, the interest of a tenant in common (also referred to as a "co-tenant") is unilaterally severable and devisable, so the creditor of a co-tenant may be able to reach a co-tenant's fractional share of the property.

Changing title is not without its risks. If a change of title is seen as a fraudulent conveyance, it will most likely be invalidated by courts. Consequently, a change in title should be carefully reviewed in advance by the owner's legal counsel.

Changing the Form of Property

Additionally, individuals can change the form of property by exchanging liquid assets for interests in a limited partnership ("LP") or a limited liability company ("LLC"). When the asset owned by an individual is an LP interest, a court can "charge" the LP interest with the payment of an unsatisfied debt, effectively assigning it to the creditor. The assignment does not make the creditor a partner or give the creditor an ownership interest. Instead, the "charging order" limits the creditor's recovery to the distributions which the individual—the limited partner—would receive. Many state LLC statutes have charging order provisions similar to those applied to LPs. In some states, however, a charging order is not the exclusive remedy of the creditor of an LP or LLC owner. For instance, in some states a creditor with a charging order may foreclose on a partner's interest in the partnership.

Special Assets

Certain assets such as qualified retirement plans, individual retirement accounts, principal residences (homestead), annuity contracts, and the cash surrender value and/or proceeds of a life insurance contract may be afforded special treatment under federal law (including bankruptcy laws) or state law and may be protected from the claims of creditors in whole or in part. It should be noted that the rules against fraudulent conveyances also apply to funds contributed to retirement plans, which can result in the voiding of the transfer and the payment of the amounts involved in such fraudulent conveyance to valid creditors.

Conclusion

There are ways for clients to potentially protect themselves from creditors. However, as the laws vary from jurisdiction to jurisdiction and their application depends upon specific facts and circumstances, the client should consult with legal counsel before proceeding.

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Prior to implementing any strategies discussed herein, please discuss them with your legal counsel and tax advisor. Certain asset protection strategies require that there be a change in part or all of the ownership of assets, which may result in the current owner no longer owning such assets.

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