

## *Idea of the Month*

### **Protecting Your Assets**

Henry David Thoreau once said “It is characteristic of wisdom not to do desperate things.” However, sometimes desperate economies produce people disposed to a lack of wisdom. The threat to wealth posed by creditors, our litigious society, and estate taxation has investors asking about asset-protection planning to protect themselves, their children and their grandchildren.

And indeed, it is perfectly legitimate for you to arrange your assets in a way that will preserve as much value as possible for you and your family in the face of an assault on your wealth. You can also use the tools of asset protection to protect loved ones from themselves.

At Contango, asset protection does not mean hiding assets to avoid US taxation or legitimate claims from current creditors. Further, we do not generally advocate offshore strategies you see advertised in the general media because you can all too easily become a victim of fraud or fall foul of complex money-laundering laws.

#### **Insurance**

When analyzing the effectiveness of your asset-protection strategy, ensuring that you have enough property and casualty insurance is a good place to begin. Spending a few dollars more for your homeowners and auto insurance policies now can protect you from greater losses in the future.

In addition, when used in concert with other asset-protection measures, an umbrella insurance policy can be an extremely successful and cost-effective way to protect against many types of liabilities and losses. For a relatively nominal cost, umbrella policies typically offer from \$1 million to \$50 million in additional coverage.

Finally, many people overlook errors and omissions insurance, which is particularly important for individuals serving on the board of a company or charity.

#### **Retirement Plans**

Assets in your retirement plans are generally protected by one of two federal laws, the Employee Retirement Income Security Act of 1974 (ERISA) and federal bankruptcy law. However, not all types of retirement plans are created equal.

ERISA is the primary federal law under which qualified plan assets receive protection, and that protection is virtually impenetrable. The covered employee retirement plans that are regulated by ERISA, and thus afforded its protection, include 401(k) and 403(b) plans, defined benefit plans, money-purchase plans and profit-sharing plans.

Not all plans operate under ERISA law. Those that do not are covered under federal bankruptcy law. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“the Bankruptcy Act”) now supersedes state laws with respect to non-ERISA plans. The Bankruptcy Act provides an unlimited exemption from the bankruptcy estate for all rollover IRAs, Simplified Employee Pensions (SEP) IRAs, and Savings Incentive Match Plan for Employees (SIMPLE) IRAs.

Contributory IRAs (i.e., traditional and Roth IRAs) are also afforded protection in the form of a \$1 million exemption, which a court may increase in the interests of justice if the assets are deemed "reasonably necessary" to support the debtor and the debtor's family.

### **Life Insurance**

The cash value of life insurance policies may not have as much protection from creditors as you think. Life insurance is regulated by state law, and state rules differ in their treatment of an owner's interest in the policy and a beneficiary's interest in the proceeds from the policies. For example, if you live in Colorado, up to \$50,000 of cash surrender value is protected and the death benefit payable to a beneficiary is wholly exempt from creditors. In Nevada, a resident can protect the amount of insurance that \$1,000 per year of premium can buy, and the beneficiary's interest is also fully protected.

### **Personal Residence**

As with life insurance, state law controls how much protection is available directly for your personal residence. If you live in Florida, all the equity in your residence is protected. Within the Zions Bancorp footprint, Nevada law generally allows for protection of up to \$550,000 of your equity, whereas if you live in Utah, you can protect your equity only up to \$20,000 per individual owner.

### **How Assets Are Owned – Choice of Entity**

How you hold assets or conduct a business will have a strong effect on the personal asset-protection risks you face. In the US, the corporate form of organization provides the most protection for your personal assets. This is because one of the key characteristics of the corporate form is limited liability. Limited liability company (LLC) or limited liability partnership (LLP) forms of organization also provide substantial protection for the partners' personal assets. This is because the partners of LLCs or LLPs are generally not held liable for the professional malpractice or tortuous conduct of the firm, the other partners, and the employees.

On the other hand, the general partnership form of organization will generally provide the least asset protection for general partners because they will have unlimited personal liability for the professional malpractice or tortuous conduct committed by the firm, the other partners, and the employees.

State legislatures have built on these basic concepts to enhance the liability protection for other members or partners of an LLC or LLP. In many states, the only recovery available to a creditor of an LLC or LLP member is a "charging order." Here is an illustration:

Mr. X is a member of an LLC. A friend of his is attacked and injured by Mr. X's pet chimpanzee. The friend recovers what she can from his homeowners insurance policy. Knowing that Mr. X "owns" a business, she then brings suit for an additional sum. Because the business is an LLC that follows all business formalities, the assets of the business itself are not at risk. The court cannot order the business to sell assets or to distribute assets to Mr. X to satisfy the judgment because doing so would damage the business and its other members. The court *can* issue a charging order that gives the friend the right to collect from any distribution that the LLC makes to Mr. X (although not from the LLC itself).

The charging order is one of the reasons that planners use family LLCs and family LLPs to hold family assets. If Junior does something less than wise and has creditor problems, Mom and Dad can delay distributions to Junior until the issue is resolved.

### **Using Entities to Compartmentalize Risk**

When risk and problems are "compartmentalized" into different businesses or entities, a creditor's claim, although problematic for one business unit, will not destroy the entire entity. Real estate developers and owners understand this well. It is common practice to own each property or project through its own entity, often an LLC or LLP. One of the key benefits is that liability that arises with one property is restricted to the entity that owns the property, thus protecting other properties and personal assets.

### **Using Trusts to Protect Others**

Trusts come in many forms, some offering no real asset protection and others offering a lot. A basic living trust, which is the foundation of an estate plan, offers no asset protection to you personally because it is revocable by you and you serve as its trustee. Legally you still own the assets, so they are available to creditors.

Generally, in order for a trust to provide meaningful asset protection, it must be irrevocable, should include "spendthrift" provisions designed to protect beneficiaries from creditor claims, and must have an independent trustee. In cases where beneficiaries have access to trust assets only in the discretion of independent trustees, courts have shielded the assets from the beneficiaries' creditors.

These features of irrevocable trusts make them a powerful tool for protecting your family from themselves and outside powers. This can be illustrated as follows:

Mrs. Z loves her adult daughter, Jill. Jill has always worked hard and saved for a rainy day, but her husband, Bill, is always out of work, spends recklessly, and has totaled three cars since they got married. His family is always begging them for money. Mrs. Z trusts her daughter but not Bill. She knows that it would be difficult for Jill to say no to her husband's spending. To resolve these concerns, within her current estate plan Mrs. Z has laid out the terms of a trust for the benefit of Jill that will fund upon Mrs. Z's death. The Jill trust, when it comes into existence, will be irrevocable. Often corporate trustees like Western National Trust Company are used as independent, long-lived trustees for irrevocable trusts.

### **Using Trusts to Protect Yourself**

While irrevocable trusts are commonly used to protect others in the US, historically these protections did not extend to permitting you to put your own assets beyond the reach of creditors. Because many overseas jurisdictions, such as the Cayman Islands, allow these "self-settled" trusts, many individuals have created offshore asset-protection trusts. In practice, these offshore arrangements are difficult to operate and they provide no US tax benefits. Further, US courts are not friendly toward offshore transfers for asset-protection purposes, and our government has made it increasingly cumbersome for Americans to maintain these structures.

In response, a few states have passed laws allowing self-settled asset-protection trusts. States that offer asset protection for self-settled trusts include Nevada, Utah, Alaska, Delaware and South Dakota. Using a self-settled asset-protection trust is most effective for individuals residing in these jurisdictions. We know, for example, that a Nevada court will follow Nevada law with respect to a Nevada resident. We do not know, however, if a California resident who is sued by a creditor in a California court could have that court respect the Nevada law for the trust.

### **Timing Is Key in Asset Protection**

Many people seek advice too late. Both inside and outside bankruptcy, there is a body of law that deals with fraudulent transfers. These laws state that transfers made close to the time of a potentially negative event such as a lawsuit can be rejected by the court as fraudulent. Therefore, it is essential that you set up an asset-protection plan before problems arise.

Specifically, to prevent having transfers considered fraudulent, you cannot wait until you are hit by a judgment before you decide to transfer assets. Transfers of any assets away from the owner must be done before an incident. This is true for a trust, a corporation, a partnership or an outright gift.

### **Putting It All Together**

Folks with children or grandchildren may be familiar with the 2001 movie *Shrek*. In the movie, there is an exchange between the hero, Shrek, and his sidekick, Donkey, where Shrek tells Donkey that “Ogres are like onions.”

Donkey is confused by this and Shrek explains that “onions have layers. Ogres have layers.” Asset protection is like an onion. It is done in layers. The first layer is to use caution in your dealings and activities. The second layer is to understand your insurance. The third layer is to use entities to isolate risk. And the fourth layer is to use trusts to protect your family and possibly yourself. Some of you need only a layer or two. Some of you, though, need multiple layers to maximize your level of legal protection.

*If you would like to discuss how you can best protect your assets, please contact your Contango advisor.*

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#### **IMPORTANT NOTES:**

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