

Covering your Ass(ets): What you Need to Know About Asset Protection in Texas

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Presentation Outline

- Asset protection, generally
- Voidable transfer laws
- Types of creditors
- Statutory exemptions under federal and state law
- Types of liabilities and client concerns
- Mechanisms available to protect property
 - Entity planning
 - Trust planning
- Analyzing client risk

Asset Protection, generally

- What is asset protection?
 - Asset protection is a wealth preservation tool that helps to limit or confine liabilities of unrelated creditors.
 - When is it appropriate – protection from contingent, unknown, or overzealous judgment creditors. But generally, not *known* creditors.
 - ❖ Works with foundational goal of estate and wealth planning: accumulate, shelter, preserve, protect, and transmit wealth.
 - ❖ Litigious society and economic instability
 - Once suit is pending or creditor claim positioned, it can be too late and challenging to find legal and legitimate ways to reduce vulnerability.
 - Cannot stop a suit, though; you can most often merely improve bargaining position and incentivize settlement or deter litigation with perception of less access to assets.

Voidable Transfer Laws

- Texas voidable transfer law, Title 3, Chapter 24 of the Texas Business and Commerce Code, is based largely on the Uniform Fraudulent Transfer Act and articulates creditor rights.
- Fraudulent transfer is one (i) with the actual intent to hinder, delay or defraud a creditor of the debtor, or (ii) without receiving a reasonably equivalent value in exchange for the transfer or obligation. If the transfer is successfully attacked, the creditor can reach the asset to satisfy the debt.
 - If a court finds a fraudulent or voidable transfer occurred, the creditor's remedies can be any relief necessary, including:
 - ❖ Avoidance of the transfer to satisfy the claim
 - ❖ Attachment to transferred asset
 - ❖ Injunction of further transfer/disposition
 - ❖ Appointment of receiver
 - ❖ Order levying transferred asset
 - ❖ Potential denial of bankruptcy protection (a very bad result for the client!)

Voidable Transfer Laws

- Both present and future creditors may void transfers.
- Present creditors generally have greater protection.
- Spotting a voidable transfer: If the debtor made the transfer in exchange for less than “reasonably equivalent value,” and the debtor was either left with an unreasonably small amount of assets under the facts or intended to incur debts beyond her ability to pay them (*i.e.*, insolvency based on the income or balance sheet test).

Understanding Creditors

- Current/Present Creditors – previously committed tort, outstanding judgement, existing debt, etc.
 - A fraudulent transfer occurs when the transfer renders the transferor insolvent (regardless of intent).
- Future Creditors
 - Potential: A reasonable expectation of forthcoming claim. Intent to defraud creditor can be critical because of timing and facts. The following are examples of facts that can support transferor intent:
 - ❖ Retained possession or control of the transferred property following the transfer;
 - ❖ Transfer of substantially all of debtor's assets;
 - ❖ Transfer occurred shortly before or shortly after a substantial debt was incurred; or
 - ❖ Before the transfer was made or obligation was incurred, the debtor was sued or threatened with suit.
 - Unknown creditor

Assets Protected Under Federal Law

- Federal law exempts qualified retirement plans governed by the Employment Retirement Income Security Act (“ERISA”).
- Qualified retirement plans include pension plans, employee stock ownership plans, profit sharing, and 401(k) plans.
 - Qualified plans are not protected from qualified domestic relations order (“QDRO,” which is related to divorce of plan participants) or IRS debt.
- ERISA does not protect IRAs.

Assets Protected Under Texas Law

1. Homestead: unlimited in value (§§ 50–52 of Article XVI of the Texas Constitution; Tex. Prop. Code § 41.001)
 - Rural and urban
 - ❖ Urban: up to 10 acres may consist of one or more contiguous lots, located within a city, town, or municipality and has access to fire protection and public utilities at the time the homestead designation is made.
 - ❖ Rural: 200 acres and improvements for families or up to 100 acres and improvements for a single adult; not served by fire protection and public utilities when the designation is made.
 - Designating
 - ❖ Must currently use as homestead or presently intend to use as homestead in the reasonably near future.
 - ❖ No declaration required but homestead property tax designation often follows.

Assets Protected Under Texas Law

1. Homestead

- Maintaining: Homestead continues until abandoned (requires both spouses, irrespective of separate or community property (Tex. Fam. Code § 5.001)), another homestead is acquired, or death (subject to continuation of homestead rights by spouse or child).
- Permitted encumbrances: (i) purchase money; (ii) taxes due on the property; (iii) amounts incurred for home improvements; (iv) owelty of partition; (v) refinance of an existing homestead lien, including a Federal tax lien; (vi) home equity loan; and (vii) reverse mortgage.

Assets Protected Under Texas Law

1. Homestead

➤ Additional protections for spouses and minors

- ❖ A spouse can convey homestead property to anyone he chooses at death, but it remains subject to surviving spouse's continued homestead right.
- ❖ Homestead rights continue for surviving spouse until death, or surrender (regardless of remarriage).
- ❖ Right continues for minors until the age of majority.

➤ Exceptions

- ❖ Liens arising before property was designated as homestead are enforceable.
- ❖ Federal tax liens are superior to homestead exemption, *i.e.*, the IRS can foreclose on homestead.
- ❖ Homestead subject to purchase money liens (*i.e.*, mortgages).

Assets Protected Under Texas Law

2. Income and income equivalents

- Wages in the hand of employer
- Unpaid commissions
- Unemployment compensation
- Workers' compensation
- Public assistance
- Medical assistance
- Officers' and firefighters' survivors' benefits

Assets Protected Under Texas Law

3. Life insurance and annuities (Tex. Insur. Code § 1108.001–.052)

- Policy and cash value during insured's life: cash surrender value to be provided to an insured under an insurance policy or annuity contract are fully exempt from garnishment, attachment, or other seizure.
- Proceeds at and after death to be paid to a beneficiary (including the estate) are also exempt.
- Exceptions:
 - ❖ Premiums paid fraudulently (to avoid a creditor).
 - ❖ insurance policies you have pledged or collateralized to secure a loan or other debt.
 - ❖ Life insurance or annuities are not protected from child support liens.

Assets Protected Under Texas Law

4. Retirement plans (Tex. Prop. Code § 42.0021)

- Stock bonus; pension; profit-sharing; etc., including a retirement plan for self-employed individuals; any annuity or similar contract; and any individual retirement account; Roth IRA; or inherited Roth IRA, etc. (vested or not).

5. College savings plans and prepaid tuition (Tex. Prop. Code § 42.0022)

- Payments or benefits from, any fund or plan established under Subchapters F and G of Chapter 54 of the Texas Education Code, or any qualified tuition program of any state that meets the requirements of Section 529 of the Internal Revenue Code.
 - ❖ Prepaid Educational Arrangements
 - ❖ Educational Savings Account Arrangements
 - ❖ Qualified Tuition Programs by Educational Institutions

Assets Protected Under Texas Law

6. Personal property up to \$100,000 for families or \$50,000 for individuals is exempt from seizure, including (Tex. Prop. Code § 42.001–.002):
- (i) Home furnishing, including family heirlooms; (ii) provisions for consumption; (iii) farming or ranching vehicles and implements; (iv) tools, equipment, books, and apparatus, including boats and motor vehicles used in a trade or profession; (v) wearing apparel; (vi) jewelry, not to exceed 25% of the aggregate limitations; (vii) two firearms; (viii) athletic and sporting equipment, including bicycles; (ix) two-wheeled, three-wheeled, or four-wheeled motor vehicle for each member of a family or single adult who holds a driver's license or who does not hold a driver's license but who relies on another person to operate the vehicle for the benefit of the nonlicensed person; (x) the following animals and forage on hand for their consumption: (a) two horses, mules, or donkeys and a saddle, blanket, and bridle for each; (b) 12 head of cattle; (c) 60 head of other types of livestock; and (d) 120 fowl; and (xi) household pets.
 - The following personal property is exempt and not included in the aggregate limitations above: (i) professionally prescribed health aids of a debtor or a dependent of a debtor; (ii) alimony, support, or separate maintenance received or to be received by the debtor for the support of the debtor or a dependent of the debtor; and (iii) a religious bible or other book.

Summary of Assets Protected Under Texas Law

1. Homestead
2. Income and equivalents
3. Life insurance and annuities
4. Retirement plans
5. College savings plans
6. Personal property up to \$100,000 for families or \$50,000 for individuals

Marital Property

- Character of property determines what is reachable by creditors
 - Characterization of property as separate or community
 - ❖ Generally, separate property is not subject to claims of spouse's creditors, except to fulfill contract for "necessities" (because spouses have a duty to support each other). (Tex. Fam. Code § 3.202(a))
 - ❖ Generally, spouses' creditors can access joint management community property whether incurred before or during marriage. (Tex. Fam. Code § 3.202(b)–(d))
 - ❖ But, sole management community property is exempt from spouse's liabilities incurred before marriage and contractual liabilities incurred during marriage. Sole management community property is subject to tortious liabilities incurred during marriage.
 - Premarital Agreements and Post-Marital Agreements (*i.e.*, agreements to convert separate to community property or vice versa) (Tex. Fam. Code § 4.001–.010)
 - ❖ Cannot diminish rights of preexisting creditor. (Tex. Fam. Code § 4.106, .206)

Intrinsic v. Extrinsic Liabilities

- Intrinsic liabilities: liabilities of the entity, such as judgments incurred with respect to the ownership or operation of the partnership assets, or contractual liabilities incurred on behalf of the entity
 - Limited partners are not liable for intrinsic liabilities except to the extent of their investment in the partnership or the extent a limited partner controls or takes actions such that it appears such partner is the general partner
 - General partners are jointly and severally liable for intrinsic liabilities of the partnership
 - LLC members are generally not liable for liabilities of the company
- Extrinsic liabilities: liabilities of a partner or member which are unrelated to the entity or the ownership and operation of the entity; for example:
 - Member in car accident or breach of contract suit
 - Member engaged in profession unrelated to the entity for which there is significant risk of potential tort claims (e.g., doctor or lawyer)

Entity Planning

- Limited partnerships (LP) and limited liability companies (LLC)
 - Generally, a Texas LP or LLC is not subject to creditors of partner or member.
 - ❖ Creditor of partner or member can obtain a “charging order” against debtor’s interest in LP or LLC.
 - A member of an LLC and a limited partner of an LP are not liable for the debts, liabilities, or obligations of the entity. A general partner of an LP, however, is liable for partnership debts.
 - ❖ Consider an LLC general partner.
 - Avoid mixing low-risk and high-risk assets.
 - Partition may also help but, weigh benefit against cost of loss of basis adjustment of surviving spouse’s interests.

Charging Order

- Charging order is the principal remedy of a partner's or member's creditor (TRLPA § 7.03(a), LLC Act, Art. 4.06)
 - Charging order is a post-judgement court order requiring a partner or member to pay distributions to the creditor until debt is satisfied.
 - Similar to a lien on the partnership or membership interest.
 - Creditor does *not* step into shoes of partner or member.
 - Intended to protect the entity from disruption of the entity business as a result of foreclosure on partnership assets by a creditor of a partner or member and resulting injustice to the other entity owners.
 - Requires that the partnership or LLC distribute to the creditor the debtor's share of distributions when, and if, distributions are made to the partners or members. The creditor generally has no power to compel distributions by the partnership or LLC, and does not succeed to the voting rights of the debtor by virtue of the charging order. The rights of the creditor are limited to those rights accorded an assignee of a partnership or LLC interest.

Trust Planning

- Irrevocable v. Revocable Trusts
 - Assets of revocable trusts are generally considered to be owned by settlor.
 - Assets of irrevocable trusts depend on identifying the beneficiary (*i.e.*, trusts for settlor v. trusts for others).
- Spendthrift trusts – sufficient to voluntarily or involuntarily restrain alienation of the interest by a beneficiary to the maximum extent permitted by law.
 - The terms of a trust may provide that the interest of a beneficiary in the income or principal may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. (Tex. Trust Code § 112.035(a))
 - Spendthrift provisions in trust agreements will protect trust assets from beneficiary's creditors.
 - But if the settlor is also a beneficiary of the trust, a spendthrift provision does not prevent the settlor's creditors from satisfying claims from the settlor's interest in the trust estate. ((Tex. Trust Code § 112.035(d))

Trust Planning

- Self-settled trusts – generally, when a settlor contributes assets to a trust for his or her own benefit.
 - Important to understand when the settlor is also considered a beneficiary of a trust.
 - ❖ A trust created by settlor’s spouse is generally not considered to be self-settled. (Tex. Trust Code § 112.035(g))
 - About 20 states currently recognize asset protection trusts (sometimes called “DAPT”).
 - ❖ These laws vary but most have some exemptions (e.g., protections) for creditors.
 - ❖ DAPTs are entirely governed by state law and are not availed of federal protections.
 - ❖ Must have a nexus with the jurisdiction; usually accomplished by appointing (and paying for) a corporate trustee in that jurisdiction.
 - ❖ Full faith and credit between states.
 - Texas Legislature has, on several occasions, contemplated the expansion of asset protection trust law to include self-settled trusts, but has not yet done so.

Does Your Client NEED Asset Protection?

- For the vast majority of individuals, the bulk of wealth is the homestead and retirement accounts so drastic or complicated asset protection measures are likely unnecessary.
- For individuals concerned with claims and lawsuits that typical liability policies may not cover, umbrella coverage might provide the necessary protection.
- For our high net worth and ultra high net worth clients with additional assets at risk to creditors, it is a good idea to analyze the facts and consider applicable asset protection planning.

How Much Asset Protection Do I Need?

- Solvency analysis, for example:

30,000,000 Total Assets

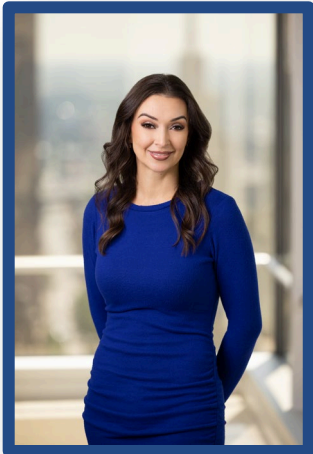
(2,000,000) Current Debts

(1,000,000) Claims, guarantees, contingent liabilities, threats, etc.

(10,000,000) protected assets, e.g., ERISA plan, homestead, annuities, life insurance

17,000,000 Unprotected Net Worth

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Jana represents individuals and multi-generational families. She primarily focuses on tax planning, drafting complex wills and trusts, implementing wealth preservation strategies, and charitable giving. Jana emphasizes helping clients achieve their objectives by designing creative and functional solutions tailored to their specific goals—whether it involves business establishment or reorganization or facilitating the administration of a trust or estate.

Jana draws from a vast breadth of experience in her law practice. Prior to joining the firm, she managed a large horse ranch and cultivated successful real estate and insurance practices. Jana’s business-focused background allows her to understand her clients’ concerns and employ a practical approach to tax, estate, and business planning issues.

She holds an LL.M. in Taxation from Georgetown University Law Center with an academic concentration in Estate Planning. During her time at Georgetown, Jana served as an extern for the United States Department of Justice, Tax Division. While working on her J.D., Jana completed her Master’s degree in Personal Financial Planning, represented pro bono clients in tax controversy matters with the IRS, served as a Peer Financial Counselor, and clerked for the Honorable Robert L. Jones, United States Bankruptcy Court, Northern District of Texas.

Jana is admitted to practice law in Texas, is Board Certified in Estate Planning and Probate by the Texas Board of Legal Specialization, and is a Certified Financial Planner, CFP®.

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