How to Protect Your Assets in North Carolina

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It's not hard to imagine a white-bearded old-timer somewhere up in the North Carolina mountains up early one morning, barely visible through the mist as his spade turns up dirt. He is burying an old WWII ammo can underneath a tree out back, filled with some jewelry he has collected over his lifetime, cash neatly double-wrapped in gallon Ziploc bags, and his collection of gold and silver coins. He feels relieved when this job is done.

Modern asset protection estate planning still represents a hedge against hard times; insurance against financial disaster. In North Carolina, an adult may plan in advance to make smart use of existing laws to protect a "nest egg" of assets against misfortune. Asset protection estate planning may protect assets against future hazards such as 1) the death or divorce of a spouse; 2) medical or other creditors; 3) uninsured legal liability or legal liability in excess of insurance limits; 4) bankruptcy brought about by loss of a job, illness, high healthcare costs (or for other reasons) 5) Medicaid estate recovery and other estate creditors; 6) business risks.

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Types of Creditors

In this article, I will break creditors into two principal groups: "creditors during life," and "estate creditors." The law and statutes applying to these two groups of creditors in North Carolina are frequently different.

Creditors During Life

In general, federal and North Carolina law describe three types of creditors during life: 1) present creditors (the debtor's obligation to the creditor already exists); 2) known potential future creditors (a potential debtor can reasonably foresee the potential future creditor making a claim, for example a victim of an auto accident who has not filed a lawsuit yet); and 3) an unknown future creditor (a future creditor that the potential debtor cannot reasonably foresee, for example a future hospital creditor with respect to a potential debtor's future illness.)

Advance asset protection estate planning can best prepare against creditor type 3 above, the unknown future creditor that the client cannot reasonably foresee. Because both federal and North Carolina debtor/creditor law allows attorneys to most effectively protect against future problems that have not happened yet, early planning is the most reliable way to protect assets.

Under both federal and North Carolina law, it is frequently too late to utilize asset protection estate planning to protect clients against present or identifiable future creditors. Moving assets out of the estate without receiving market value in return, or attempting to hide assets away once an identifiable creditor obligation is established, may be voided or overturned by a court in favor of the creditor, under federal or North Carolina fraudulent conveyance law. N.C. Gen Stat. § 39-23.5(a) and 28 U.S.C. § 3304.

Estate Creditors

Debts incurred during life, which have not been paid before someone dies, may be collected from the deceased person's (decedent's) estate under North Carolina estate administration (probate) statutes. N.C. Gen. Stat. § 28A.

North Carolina probate law requires all timely and valid creditors of an estate to be paid before assets are distributed to beneficiaries through a will, or by intestate succession (the statutory process for distributing probate estate assets to beneficiaries when a person dies without a will), or by other means.

Thus, estate creditor claims can reduce, or eliminate, the decedent's assets that he or she intended to leave for loved ones. Estate creditors may cause loved ones to inherit a reduced amount, or not to inherit at all.

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If a person had to use Medicaid during his or her life to pay for health care, long term care, or nursing home expenses, Medicaid keeps track of every dollar it spends on the Medicaid recipient during his or her life. If there are assets left in an estate after the Medicaid recipient dies, such as the decedent's home, in many cases Medicaid will apply as a creditor to the Medicaid recipient's estate during probate, seeking payment of the Medicaid bill from the assets left in the estate. This federally-mandated process is called Medicaid Estate Recovery, and is reliably directed in North Carolina from an office in Raleigh. 42 U.S.C. § 1396(p)(b).

In addition to Medicaid, medical estate creditors are common. Medical care at the end of life may be extremely expensive. Unpaid hospital and other medical care bills may be attached to the ill person's estate following death. Such bills may be quite large, and may add many thousands of dollars in debt to an estate following an ill person's death. Too many bills may bankrupt an estate, so that a deceased person's intended estate beneficiaries receive nothing.

Asset Protection Methods That Do Not Work

Frequently, the following techniques are mistakenly thought to protect assets from creditors. These do not work, however, in North Carolina.

Revocable Trusts

During the grantor's (the person who sets up the trust) lifetime, the assets within the grantor's revocable trust are specifically available to the grantor's creditors, as provided by statute. N.C. Gen. Stat. § 36C-5-505(a)(1).

Even though a revocable trust may keep assets out of the probate process, North Carolina law allows estate creditors to access assets in a decedent's revocable trust in order to pay probate creditor claims. N.C. Gen. Stat. § 36C-5-505(a)(3).

A revocable trust document may, however, also contain one or more testamentary subtrusts, such as a marital trust or family trust. Even though the original revocable trust does not protect against estate creditor claims against the decedent's estate, once all creditors' claims are paid in probate and that process has ended, assets remaining in the revocable trust may then be protected within any testamentary irrevocable subtrust(s) left for the spouse or children, or for another third-party. If such irrevocable subtrusts are properly constructed, they may then protect the assets held within them from creditors of the beneficiaries. See more information on third-party irrevocable trusts below.

Joint Bank Accounts With Rights of Survivorship

Even though a joint bank or securities account with the right of survivorship (frequently established by married couples) will initially keep the assets held within that account out of the

probate process, the account assets may be called back into probate to satisfy creditor claims against the decedent's estate. N.C. Gen. Stat. § 28A-15-10(a)(3).

Transfer on Death / Payable on Death Accounts

Even though Transfer on Death (TOD) or Payable on Death (POD) bank or securities accounts are initially transferred to beneficiaries outside of probate, these assets are subject to the debts of the decedent, and may be called back into probate to satisfy creditor claims against the decedent's estate. N.C. Gen. Stat. § 41-48(b).

Best Asset Protection Techniques For North Carolina

Gifting

An asset that is gifted out of a person's estate is not normally subject to the claims of the giver's unknown future creditors. This technique can preserve the asset for another family member, and can preserve the net value of family assets in close families. Once gifted, the receiving party can decide to later benefit the giver if needed with some or all of these assets, but the recipient is under no legal obligation to do so.

Once an asset is given away, the giver normally has no legal recourse to get it back. Losing title to the gift asset, or the legal ability to benefit from the asset, limits this technique in practice. In addition, if the giver may later need Medicaid to help with long term care or other medical costs, any gift made within 5 years of applying to Medicaid may violate Medicaid's 5 year lookback requirement, and create a costly penalty for the Medicaid applicant.

Retirement Accounts

Individual retirement account (IRA) assets are generally well-protected against creditors in North Carolina, along with qualified retirement plans, and qualified profit-sharing plans. Such accounts are protected against creditors during the account contributor's lifetime, and rollovers or direct transfers to account beneficiaries are generally protected following death. Inherited IRAs to beneficiaries generally continue to be protected following the contributor's death under North Carolina state law. N.C. Gen. Stat. § 1C-1601(a).

The U.S. Supreme Court ruled in 2014 that assets held in an inherited IRA for a non-spouse no longer constitute protected retirement funds for federal bankruptcy purposes, thus are not protected from creditors' claims when a non-spouse inherited IRA beneficiary files for bankruptcy. Clark v. Rameker, 134 S. Ct. 2242 (2014). Although North Carolina law generally does protect non-spouse inherited IRA beneficiary residents against creditor claims, because of the Clark v. Rameker decision, non-spouse inherited IRA beneficiaries who live outside of North Carolina, or who move outside of North Carolina, could lose creditor protection on their inherited IRA assets.

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Any basic asset protection strategy should include annual contributions (maximum contributions if possible) to IRA accounts. In addition to conveying tax benefits, IRAs remain broadly protected against creditors in North Carolina.

Life, Liability, and Health Insurance

The cash value of life insurance policies which name the insured person's spouse or children as beneficiaries have long been protected against creditors in North Carolina, under the North Carolina Constitution. Life insurance payouts to these beneficiaries, following the insured person's death, are protected against the insured person's estate creditors also. N.C. Gen. Stat. § 1C-1601(6); N.C. Const. art. X, § 5.

Once a spouse or child receives the life insurance proceeds, however, the life insurance proceeds are no longer protected. The insured may instead leave life insurance proceeds to a protected third-party irrevocable trust benefitting his or her spouse or children, which can protect the insurance proceeds from their creditors. See more about third-party trusts below.

In North Carolina, purchasing a life insurance policy to benefit loved ones may make great sense. When adults are younger, and may not have many assets saved up yet, purchasing a life insurance policy (which is normally less expensive when purchased by a younger adult) may be an economical way of funding a family trust for a spouse or children left behind, in case the insured passes away.

Life insurance policies may be available to older adults also. Given the strong creditor protection benefits in North Carolina, purchasing life insurance can be an excellent way of insuring that assets that a person leaves behind to benefit a spouse or children will reach them without problems.

Purchasing liability insurance or health insurance may lower creditor risk also. Purchasing automobile, boat, motorcycle, RV, homeowners, landlord or landowners, business liability, or professional malpractice insurance may additionally protect personal assets against legal liability claims, and make associated financial problems (with attendant creditor claims) or personal bankruptcy less likely. Purchasing appropriate health insurance, or a long-term care or disability policy may make it less likely that a serious illness will lead to insurmountable medical creditor debt.

Tenancy by the Entirety Property

A tenancy by the entirety represents a unique way for married couples to concurrently own real property (land and buildings on the land.) Its common law history stretches back to old England, and is rooted in the Biblical story of God creating Eve: "This at last is bone of my bones and flesh of my flesh…" "Therefore a man shall leave his father and his mother and hold fast to his wife, and they shall become one flesh." *Genesis* 2:23-24 (King James).

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English jurist William Blackstone describes real property held by husband and wife as one indivisible unit, without equal parts or shares, and noted that "husband and wife are considered one person in law." William Blackstone, Commentaries on the Laws of England 182 (9th ed. 1783).

In North Carolina, real property purchased by husband and wife during their marriage, or converted during their marriage, may be held in a tenancy by the entirety. Tenancy by the entirety ownership conveys both 1) a right of survivorship (if one member of the married couple dies, the survivor immediately owns the whole property); and 2) creditor protection against the creditors of one indebted spouse.

If one spouse becomes indebted to a creditor(s) in North Carolina, and not the other, as long as the marriage lasts, the creditor cannot attach or take entireties real property concurrently held with the unindebted spouse. In addition, if the indebted spouse dies, the entireties property will immediately transfer to the surviving member of the couple by operation of law, free from the indebted spouse's creditor.

Thus, a married couple holding real property in a tenancy by the entirety conveys significant creditor protection to the couple. Holding entireties property has limits as an asset protection strategy, however. If the couple becomes divorced, the creditor protection stops for the indebted spouse. Because death also severs this tenancy, if one member of the couple dies, leaving an indebted spouse, the creditors of the indebted spouse can immediately attach the real property (now wholly owned by the surviving indebted spouse.)

If the surviving indebted spouse is age 65 or older and single, North Carolina law allows the widow or widower to keep up to a $60,000 interest in a residence formerly held in a tenancy by the entirety with his or her deceased spouse. N.C. Gen. Stat. § 1C-1601(a)(1).

A tenancy by the entirety only protects against creditors of one or the other spouse singly, but not against joint creditors of both spouses at the same time. For example, suppose a husband is driving a car that is jointly titled in both the husband and wife's name, and has an accident creating $500,000 of uninsured liability. Because auto accident liability in North Carolina may attach to both the driver of a car and all owners of the car, and the wife is also a car owner, the couple may then be jointly liable for the $500,000 debt. Tenancy by the entirety ownership of the couple's home or other real property may then not protect their real property against the joint accident liability.

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529 Plan

North Carolina law protects up to $25,000 placed in a 529 college savings plan, which benefits a child of the debtor and will actually be used for the child's college or university expenses, if the plan was purchased more than 12 months prior to a creditor obligation. N.C. Gen. Stat. § 1C-1601(a)(10).

Life Estate

To shield a person's home from all unknown future creditors, including creditors during life and estate creditors, a real property owner may gift the remainder interest in his or her home away to beneficiaries during life, while retaining a life estate, so that the giver (grantor) may legally remain in his or her home during the real property grantor's lifetime (the grantor becomes a "life tenant".) This assures that no unknown future creditors, including medical creditors such as Medicaid, will be able to place a lien on the life tenant's home following the conveyance, because the real property ownership interest has already been transferred out of the life tenant's estate to the remainder beneficiaries.

In addition to allowing the grantor to continue to use his or her home during the grantor's lifetime, retaining the life estate interest allows the grantor to include the home in his or her gross estate for federal estate tax purposes under Internal Revenue Code Section 2036. The grantor's heirs can then receive a step up in (tax) basis, re-setting the tax basis of the property to its market value at the time of the grantor's death. Because the grantor's heirs will not have to pay capital gains taxes on the amount the grantor's home appreciated during the grantor's lifetime, this can save the family thousands in capital gains taxes.

The gift transfer while retaining a life estate technique is not appropriate for seniors who may need Medicaid within 5 years. If the senior attempts to qualify for Medicaid within five years of transferring the remainder in his or her home to heirs, Medicaid will require the senior to private pay (for example to a nursing home or managed care facility) the entire value of the transfer (as determined by Medicaid's actuarial life estate chart) before Medicaid will provide any government dollars (Medicaid 5 year lookback penalty.)

In some cases, the family may be able to give the house back to the senior to avoid this Medicaid problem, but family dynamics may make this an unsure result.

A related type of deed, called an "enhanced life estate deed," or Ladybird deed, may get around the 5 year lookback problem, but this deed can be trickier to use in practice.

Joint With Rights of Survivorship Real Property

Transferring real property to joint with rights of survivorship (JTWROS) ownership may protect the transfer of real property at death from estate creditors, but not from creditors during life.

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JTWROS ownership remains quite useful however, because it can protect real property against Medicaid estate recovery (where Medicaid attaches the Medicaid bill for a person's care to their estate following the Medicaid recipient's death), and against large medical creditor bills from the end of a person's life that may commonly be attached to a person's estate following death.

An elder law attorney can retitle a person's real property as "joint with the right of survivorship", or JTWROS, in the following manner: A small percentage of the real property (frequently 1%) is sold by the property grantor to a beneficiary, such as a child (with the largest percentage ownership of the real property, frequently 99%, retained by the grantor), so that the real property will now be owned jointly (in a joint tenancy.) With respect to Medicaid, undivided real property owned jointly by a Medicaid applicant and a non-spouse third-party is currently defined as "real property held by tenants-in-common" under the North Carolina Medicaid rules, and is not a countable asset when qualifying for Medicaid in North Carolina.

Adding the "right of survivorship" to the deed re-characterizes the real property to provide survivorship rights. This means that if a property owner dies, that owner's property interest automatically transfers proportionately to any surviving property owners. If a parent grantor passes away before the other property owners, the grantor's ownership percentage (99% for example) automatically transfers by operation of law to the minority (1% for example) beneficiary(ies) (frequently the senior's child/children), so that the beneficiaries now automatically own 100%. This becomes an out-of-probate transfer directly to the grantor's beneficiaries. With respect to Medicaid, the Medicaid recipient's real property passes immediately to the recipient's beneficiary(ies), without Medicaid being able to force the sale of the real property to repay the original grantor's Medicaid costs.

Another positive result is that the grantor's heirs will not have to pay taxes on any appreciation of the home during the grantor's life. Because the home will be includable in the grantor's gross estate for federal estate tax purposes, the tax basis will be reset to the market value of the property at the senior's death, thereby potentially saving the senior's heirs thousands of dollars in capital gains taxes.

Separate Automobile Ownership / Joint With Rights of Survivorship Automobile Ownership

In North Carolina, it is best to keep car ownership in one name only for liability reasons. Although it may seem natural for couples to own a car jointly, if that vehicle is involved in an accident, the injured person's attorney can sue both an at-fault driver and all owners of the car. When a couple instead owns their vehicles only in their own names, an at-fault driver does not imperil his spouse's separate assets. Thus couples who own their cars separately can decrease their liability risk significantly, depending on how financial assets are distributed between the couple.

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Even given the increased liability risk, some people prefer to own their car jointly. Normally in North Carolina, when a couple of any kind jointly purchases a car at a dealer and does not give the dealer specific instructions about how they want the car owned, the dealer will fill out the paperwork in a way that translates into tenancy-in-common ownership on the car title. This means that each member of the couple will own a 50% undivided interest in the car (which is, unlike land, and **undividable** asset) with no survivorship rights. This can produce undesirable results.

In order for the survivor of any couple, including a married couple, to inherit a jointly-owned car in North Carolina (not held in a trust) directly (outside of probate), the joint owners must explicitly tell the dealer that they want the car owned as joint with right of survivorship, or JTWROS. They also must insure that the letters “JTWROS” or “JWROS” appear on the car title itself. Without JTWROS on the car title, there is no right of survivorship held by the surviving owner.

It is important to specifically check the car title for the JTWROS designation, because many DMV workers do not understand the JTWROS designation, or do not know that JTWROS ownership of vehicles is permitted in North Carolina.

The JTWROS designation on the car title will insure that if one of the joint car owners dies, the remaining living owner will then receive full ownership of the car (except for any portion owned by a lender), likely free of the decedent’s creditors, in an automatic out-of-probate transfer.

<u>Limited Liability Companies (LLCs) and Limited Partnerships</u>

Corporations, LLCs, and limited partnerships can be very effective at limiting the personal liability of business owners for liability arising from the business. In normal circumstances, corporate shareholders, LLC members, or limited partners are not personally liable to creditors of the business. N.C. Gen. Stat. § 55-6-22; § 57D-3-30; § 59-303.

LLCs and limited partnerships may additionally provide some protection for an owner’s share in the business against future personal creditors of the owner. In North Carolina, a creditor of an LLC interest owner may only obtain a “charging order” to attach distributions that would be ordinarily paid from the LLC business to the owner. A creditor of a limited partner only has rights to distributions or allocations from the partnership. With respect to both an LLC and a limited partnership, the owner retains the actual ownership interest in the underlying assets, and retains any voting rights attached to the ownership interest. N.C. Gen. Stat. § 57D-5-03; § 59-703.

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Irrevocable Trusts / Asset Protection Trusts

Certain types of irrevocable trusts (the trust cannot be revoked or modified by the grantor) can provide significant protection against both the grantor's unknown future creditors, and against creditors of the trust beneficiary(ies) as well.

In North Carolina, not all irrevocable trusts protect against the grantor's unknown future creditors. Self-settled irrevocable trusts generally do not protect against the grantor's future unknown creditors in North Carolina. Third-party irrevocable trusts (where the grantor does not retain a beneficial interest in the assets transferred into the trust), may be structured to protect against unknown future creditors of the grantor, and may protect against creditors of the beneficiaries.

Self-Settled Trusts. A self-settled irrevocable trust exists where a grantor places assets in an irrevocable trust, and then becomes a beneficiary of those assets. In North Carolina, self-settled trusts generally do not protect a grantor's assets placed in such a trust which later benefit the grantor. By statute, "With respect to an irrevocable trust, a creditor or assignee of the settlor [grantor] may reach the maximum amount that can be distributed to or for the settlor's benefit. N.C. Gen. Stat. § 36C-5-505(a)(2).

Federal bankruptcy law, in particular, is far-reaching when allowing creditor access to irrevocable trust funds which benefit the grantor. Under 11 U.S. Code § 548 (U.S. Bankruptcy Code; Fraudulent transfers and obligations), assets may be reached in bankruptcy which benefit the grantor/debtor within 10 years before the date that the bankruptcy petition was filed.

Third-Party Trusts. Trusts created to benefit third parties, or third-party trusts, can be drafted in North Carolina to protect against the grantor's unknown future creditors (and to protect against creditors of the third-party beneficiaries also.) Where effectively drafted, the grantor's contribution to a third-party irrevocable trust is treated by federal law as a gift to the trust under 26 U.S.C. § 2501. The IRS considers a gift to be "any transfer to an individual, either directly or indirectly, where full consideration (measured in money or money's worth) is not received in return."

Because a valid gift to a properly-drafted third-party trust transfers assets out of the grantor's estate, the gift may be well-protected against unknown future creditors of that grantor.

If the irrevocable third-party trust beneficiary(ies) is in debt, or becomes a debtor, a properly drafted third-party irrevocable trust may protect trust assets against the beneficiary's creditors in North Carolina, even if a beneficiary serves as trustee. N.C. Gen. Stat. § 36C-5-504(f).

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The following types of irrevocable third-party trusts may provide asset protection against either unknown future creditors of the grantor, creditors of the beneficiaries, or both in North Carolina:

AVAILABLE ASSET PROTECTION TRUSTS IN NORTH CAROLINA

- Testamentary trust, including marital or family trust.
- Discretionary trust. N.C. Gen. Stat. § 36C-5-504.
- Spendthrift trust. N.C. Gen. Stat. § 36C-5-502.
- Protective trust. N.C. Gen. Stat. § 36C-5-508.
- Testamentary or third-party special needs trust (SNT).
- Third-party asset protection trust (APT).
- Spousal lifetime access trust (SLAT).
- Medicaid asset protection trust (MAPT).
- Veterans' asset protection trust (VAPT).

Domestic Asset Protection Trusts / Foreign APTs

For a grantor to set up a trust which benefits the grantor (self-settled trust), while also receiving protection against unknown future creditors, the grantor must look to a state other than North Carolina, which offers a domestic asset protection trust (DAPT.)

Currently, approximately 17 states outside of North Carolina, such as Delaware, offer domestic asset protection trusts. These trusts are normally more appropriate for grantors with a significant level of assets to protect. Many states require the involvement of an institutional (bank or trust company) trustee, which may not normally manage trusts funded with less than $1 million in assets or more. The various out-of-state statutes involved may provide other restrictions on grantor and beneficiary.

Also, the law remains unsettled regarding whether a non-resident who serves as grantor on an out-of-state asset protection trust fully benefits from the laws of the DAPT state with respect to asset and creditor protection.

Offshore asset protection trusts may be available, but these are generally complex. Courts apply U.S. law in dealing with these trusts, and tax issues may also be complicated.

Keywords: Asset protection, asset protection planning, asset protection trust, irrevocable trust, estate planning, protect assets, creditors, elder law, special needs law, elder lawyer, elder attorney, estate planning attorney, estate planning lawyer.

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