Guarding the Fortress

Protecting a wealthy client's marital home or personal residence isn't easy. Here are some options to explore. By Roccy DeFrancesco

A CLIENT'S HOME MAY BE HIS OR HER castle, but even the broadest of moats can't keep determined creditors at bay. In fact, the marital home or personal residence is one of the most difficult assets to protect. A financial planner who can help clients to safeguard this important asset will earn their gratitude, along with additional business and referrals.

Homestead exemption. When devising a plan to protect your client's personal residence, the place to begin is with the homestead exemption. In every state, the value of real property is protected or exempt from judgments for debts to some extent.

The homestead exemption is quite limited in most states, however—typically $5,000 to $10,000—and is therefore of little help to most clients with any equity in their house. On the other hand, if your clients are lucky enough to live in one of the few states that has an unlimited homestead exemption, all the equity in their house will be protected.

Tenants by the entireties. A second avenue to investigate is how a state lets married couples own title to their home. Some states allow them to own property as tenants by the entireties (TE).

Owning property as TE means that each spouse has an undivided interest in the "whole" property. A creditor cannot force the sale of either spouse's interest because to do so would affect the other spouse's ability to enjoy the "whole" property. Therefore, if your clients are lucky enough to reside in a state where married couples are able to own property as TE, their marital residences will be protected.

There are some problems with TE, however. For instance, TE does not protect the marital home from joint creditors of both spouses. The classic joint creditor situation arises when a married couple has a party at their home. Let's say clients are having an office party at home. If an attendee at the party gets drunk on alcohol your clients have provided, decides to drive home, and then gets into an accident, both homeowners are liable for negligence. The other problem with TE is that a single person can't take advantage of its protection.

Qualified personal residence trust (QPRT). A QPRT is a trust set up where the personal residence is gifted to the beneficiaries in an irrevocable manner. The person gifting the house to a QPRT gets to live in the house rent-free for a specified period of years. During the term of the trust, the owner/spouse living in the residence is responsible for maintaining the property and paying taxes and expenses connected with the occupancy.

There are four main problems with a QPRT:

- Clients must give up their personal residence irrevocably (that is, they give up control of the property and could be thrown out of their own home at the end of the term);
- Clients have to use some of their estate tax credit when gifting the house to the QPRT (or pay gift taxes);
- If the clients die prior to the end of the term of years specified when setting up the QPRT, the gift will be reversed and the house included in the estate for estate tax purposes; and
- If the clients live past the end of the term, they must pay reasonable rent (non-deductible) to the QPRT.

The bottom line with a QPRT is that it will work well as an estate planning tool—if the client is over the age of 65. On the other hand, it does not work well as an asset protection tool for people under 65 due to the fact that the house must be irrevocably gifted to the trust.

Limited liability company (LLC) or family limited partnership (FLP). Both LLCs and FLPs shield assets through the protection of the “charging order.” (A charging order only gives creditors the right to pay taxes on any income generated but not distributed; it does not allow them to sell any assets or force any distributions of income.)

It’s true that if a client has a properly constructed LLC or FLP in a state with a good statute, the sole remedy a judge can give a creditor is a charging order—but does that automatically mean that using an LLC or FLP is a good idea for protecting the personal residence? The simple answer is no.

There are some significant downsides to putting a personal residence in an LLC or FLP, depending on which state you live in. First, the client can lose the capital gains tax exemption upon selling the residence. Each spouse has a $250,000 capital gains tax exemption on the sale of the personal residence (which renews itself every two years). In order to take advantage of this exemption, the spouse must live in the house and own it personally for two years out of five.

Second, the client will lose the home mortgage deduction if the residence is owned by an LLC or FLP. This is huge for most clients who have a mortgage. One of the biggest itemized deductions for clients is the home mortgage deduction, and most clients probably won’t want to forego that deduction to asset protect their personal residence.

Third, in some states (such as Michigan), if the marital residence isn’t owned individually, clients lose the ability to claim it as their “homestead.” The consequence in Michigan for not being able to claim a residence as the homestead is an unwelcome increase of more than 50% in property taxes.

Debt shields (equity stripping). While debt shields and equity stripping sound fancy or exotic, the terms simply mean taking out a large amount of debt on an important asset that otherwise has little or no debt. The theory is simple; if an asset is riddled with debt, then a creditor won’t want it. If a creditor does want it, he or she will have to stand behind the first creditor holding the loan against the valuable asset.

The rules have recently changed on debt shields. Before, a client could take out as much equity as desired, and the interest payment would be deductible. The IRS has now limited the deduction to interest on $100,000 of home equity debt or new refinance debt. The exception to this limit is on new homes. If a client with $400,000 of equity in a home sells the home, reinvests the money, and buys a new home with 100% debt on the home, all the interest is deductible.

With the typical equity stripping program, money from the loan is funneled into a cash-building life insurance policy. The policy is set up to allow the client to take tax-free loans in retirement.

> There’s no great way to asset protect the marital home—but there are avenues to explore, and your clients will appreciate your desire to be helpful.

Is equity stripping financially viable for clients? It depends. If life insurance policies perform as they have for the last 20 years and if interest rates remain anywhere near where they have been over the same time period, then the answer is that equity stripping will work well for a client financially.

Let’s look at one example of how a debt shield and equity stripping might be used to asset protect a personal residence. Dr. Smith, is a 45-year-old orthopedic surgeon. She lives in a state where the homestead exemption is $5,000 and where TE isn’t available as a way to own property. Dr. Smith recently paid off the debt on her $600,000 house and now is worried about losing her largest asset to a patient from a medical malpractice suit.

Dr. Smith is too young for a QPRT, so the only viable way to asset protect her residence is through a debt shield. Coincidentally, Dr. Smith and her husband are looking to move into a new house, so they sell their existing one and purchase a new $600,000 house with a new $600,000 mortgage (so all the interest is deductible). Dr. Smith then takes the $600,000 equity from the sale of the original house and invests it into a cash-building life insurance policy.

Dr. Smith’s loan is at 5%, with a rate lock for five years. The annual interest on the loan is $30,000, which costs her just $18,000 out of pocket because she is able to deduct the interest from her taxes (assuming that she’s in the 40% tax bracket). So Dr. Smith is really paying the after-tax equivalent of $18,000 a year for as long as she would like to asset protect her $600,000 home (which is also appreciating).

With the new life policy, Dr. Smith would have $600,000 in cash surrender value in the policy at the end of the fifth year (if she decided she didn’t want the loan any longer, then she would have the money to pay it off). And Dr. Smith would start out with a $2.1 million death benefit with the life policy.

If Dr. Smith waited until she was 65 to pay back the loan, using reasonable assumptions on interest rates and returns in the life policy, she would be able to pay back the loan and then, through income-tax-free loans, take $51,800 out of her life policy each year for 15 years. To equal the same return, Dr. Smith would have to earn 5.4% pretax in the stock market every year on the amount paid in interest.

There is no great way to asset protect the marital home or personal residence, but discussing the solutions mentioned here will showcase your knowledge and your desire to be helpful. And if a client decides a debt shield is a good solution, a commission-based adviser can make money on a topic (asset protection) that is usually not an income generator. **FP**

Roccy DeFrancesco, CWPP, is president of TriArc Advisors, a company dedicated to educating advisers about advanced planning techniques. For more information, go to www.triarcadvisors.com or contact him at roccy@triton.net or (269) 469-0537.

To take the CE Quiz online, go to www.Financial-Planning.com