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## **When Transferring Assets to a Low-risk Family Member Can Save the Day**

### **Background**

For many people, liability insurance is the primary method of asset protection. However, low coverage limits, liberal policy exclusions, insolvent insurance companies, and/or exorbitant premiums insurance coverage can sometimes leave high-risk/high-wealth individuals (e.g., a surgeon or business owner) exposed and in need of additional protection from creditor claims. One simple and inexpensive method for protecting assets in such a case is for the high-risk person to transfer (retitle) property to a low-risk family member.

To be able to spot such an opportunity, you first need to be familiar with the rules governing property ownership and how this impacts the ability of creditors to reach the property. Of course, once the opportunity is spotted, you'll likely want to get a knowledgeable attorney to take the helm, but recognizing the opportunity is the important first step.

Basically, there are the two types of property ownership (sole and concurrent) and the two systems governing the ownership of property between spouses (common law and community property). This letter will cover the asset protection implications of sole ownership and the impact of community property laws when they apply. We'll cover the asset protection implications of concurrent ownership in a future issue.

**Note:** In this letter, the term creditor is used in a broad sense, encompassing plaintiffs who win judgments in court, spouses in the context of divorce proceedings, and traditional creditors (e.g., lenders).

### **Individuals Who May Benefit from This Strategy**

The following individuals may benefit from the asset protection strategies discussed in this release:

- Someone who sold a business and wants to protect the proceeds from subsequent buyer claims.
- Professionals who are in a line of work that makes them particularly vulnerable to liability suits (e.g., doctors, dentists, lawyers, accountants, real estate developers). Licensed professionals generally cannot insulate themselves from personal liability for malpractice, even by conducting their business in a form that is generally associated with limited liability.
- Business owners who operate as sole proprietors or in partnership.
- Owners of incorporated businesses and Limited Liability Companies (LLCs) who operate in a manner that can cause the corporate veil to be pierced.
- A spouse with separate property who wants to protect it in case of divorce.
- Spouses who want to protect their property from each other's creditors.



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- Corporate officers and directors who could be held personally responsible to the shareholders or to tort and regulatory creditors of the corporation.
- Individuals vulnerable to environmental-related claims (e.g., owners of real estate).
- An individual having joint and several liability with fellow investors.

### **Sole Ownership**

Sole ownership of property is a simple concept: the sole owner has complete control over the property owned. Unless the property is exempt from creditors' claims under state or federal law (see later discussion), there are no legal barriers between creditors and a debtor's solely owned property. This unfettered access by creditors makes sole ownership by high-risk individuals (e.g., a surgeon or the owner of a retail business) undesirable for asset protection purposes. However, sole ownership can be used as a simple and inexpensive asset protection technique when a high-risk individual has a spouse or other trusted family member with low risk exposure. In such cases, it is relatively easy and inexpensive to have the high-risk individual transfer his or her ownership interest in a portion of his or her assets (preferably nonexempt assets) to the low-risk relative.

With *exempt assets*, creditors generally can't seize exempt property in satisfaction of a debt owed by the owner of the exempt property. (A creditor can still obtain a lien against the property; it just can't enforce the lien by taking the property.) Therefore, when possible, it is advisable to allocate ownership of exempt assets to high-risk spouses and nonexempt assets to low-risk spouses. Exempt assets vary by state but typically include pension plan accounts; annuity investments and life insurance cash values, proceeds, and other policy benefits; qualified tuition programs (529 plans); and homesteads.

In the 41 common law states, this tactic effectively shelters assets from creditors of one high-risk spouse by retitling them in the name of the other. In the nine community property states, a formal marital property agreement may be required to transform community property into the low-risk spouse's separate property.

#### **Example 1: Dangers of sole ownership by a high-risk spouse.**

Dr. Smith and his wife, Jane, live in a common law state. They have accumulated approximately \$1.5 million in assets over the 25 years in which Dr. Smith practiced medicine. Having retired due to a medical disability, Dr. Smith feels financially secure because he has \$1 million in a brokerage account (titled in his name as sole owner) and \$500,000 in a 401(k). The Smiths have never considered how to best title their property.

Shortly after retiring, a former patient files a malpractice lawsuit against Dr. Smith and wins a \$2 million judgment. The judgment exceeds Dr. Smith's insurance coverage by \$1.25 million. Dr. Smith's attorney regrettably informs him that the brokerage account is not exempt from creditor's claims. Therefore, since he is the sole owner of the account, the judgment creditor will be able to reach all of the assets in the account. This will effectively wipe out the Smiths' savings, except for the assets in the 401(k), which are protected as exempt assets.

The Smiths' problem could have been avoided (or at least mitigated) with proper planning. If any of Dr. Smith's advisors had recommended that he transfer some, or all, of his brokerage account assets to Jane, those assets would not be subject to the judgment. Assuming the Smiths had followed the advice, they would not have been financially wiped out due to one unforeseen lawsuit.

Before taking advantage of the credit protection offered by retitling assets into a low-risk spouse's name, it is imperative for the individual to understand that there can be adverse consequences, including the following:

- The low-risk spouse may be sued (e.g., for negligence resulting in a car accident), thereby subjecting assets, which would have been sheltered if they remained in the ownership of the high-risk spouse, to creditor claims.



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- The low-risk spouse has complete control over the transferred assets. Accordingly, the assets can be sold or otherwise transferred without the consent of the high-risk spouse.
- Transferring assets to a spouse can have negative consequences in the event of a divorce. If the transfer is a gift, it will likely create separate property for the donee spouse that generally is not subject to division in divorce proceedings.

### **Applying the Property Retitling Strategy in Community Property States**

In the nine community property states, (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), married persons generally have two types of property, separate and community. Unlike common law states, community property states look to the source of the property (not the name in which it is titled) to determine if it is separate or community property. Most community property statutes specifically describe the types of property that are separate property, and define community property as all property other than separate property.

**Note:** The following discussion focuses on general principles used in the majority of community property states. An attorney should be consulted for the specific state rules that may apply.

In community property states, a spouse's *separate property* generally includes property (a) acquired prior to the marriage; (b) acquired during the marriage by gift, inheritance, or personal injury damages award; and (c) converted to separate property by a written marital property agreement signed by both spouses. Earnings (e.g., interest and dividends) from separate property are generally considered community property unless otherwise provided in a written marital property agreement signed by both spouses.

*Community property* is usually defined as all property that is not separate property. Community property generally includes all property acquired by either spouse during marriage that is not specifically identified as separate property by a valid, written marital property agreement, or acquired by gift or inheritance. In community property states, most property acquired by the spouses during marriage is community property and will be treated as such without regard for the manner in which it is titled. Generally, property owned by either spouse is presumed to be community property unless it can be shown that the property meets the definition of separate property.

#### **Example 2: Community property not altered by naming one spouse on title.**

Joe and Judy reside in a community property state. Judy owns a bicycle rental business (which exposes her to potential lawsuits); Joe is semi-retired. Each month they deposit a portion of their income into a brokerage account titled in Joe's name. The account assets are subject to the claims of Judy's creditors because the account is community property. The fact that the account is in Joe's name has no effect in a community property state.

**Note:** In a common law state, the brokerage account would be Joe's separate property (unless there is a divorce) and would not be subject to the claims of Judy's creditors, except to the extent that deposits were fraudulent transfers.

**Asset Protection Implications of Community and Separate Property.** Creditors of one spouse (seeking to collect a separate debt of that spouse) can generally reach community property and the separate property of the spouse responsible for incurring the debt. The creditors cannot reach the other spouse's separate property. However, the other spouse's share of community property may be vulnerable, particularly if the debt was incurred on behalf of the community (e.g., the purchase of a car that both spouses use equally).

The rules governing the vulnerability of community property to claims of one spouse's creditors vary substantially among the community property states. For example, in Texas, the portion of community property under the sole management and control of one spouse (e.g., the spouse's earnings and property acquired with her earnings) can only be reached by creditors of the other spouse if their claims are for torts (e.g., negligence, assault and battery) and the claim arose during the marriage. Creditors with contract claims, and claims arising prior to the marriage, cannot



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reach the other spouse's sole management community property. In California, community property can be reached by creditors of either spouse without regard for who has management control over the property. Unlike Texas, California places all community property at risk for the debts of either spouse. Therefore, in California, there is substantial risk to holding property as community property.

**Converting Community Property to Separate Property While Retaining Control.** Because community property is generally available to satisfy debts of either spouse, it should be avoided whenever a individual's tax and investment goals will not be unduly jeopardized by converting community property to separate property. Unfortunately, dividing marital assets into separate property has permanent implications in the event of divorce, which may make such a separation undesirable to many individuals.

The easiest way to convert community property to separate property is by outright gift or partition agreement. An outright gift is made when one spouse gives the other a portion of community property under the donor spouse's control and expressly declares that he or she intends the gifted property to be the separate property of the donee spouse. A partition agreement is a contractual agreement between spouses that transforms property from community to separate. Unfortunately, for either method to be valid (i.e., recognized by the courts), spouses cannot retain or exercise control over the property transferred to or received by the other spouse.

Please give us a call if you would like to discuss this topic further.

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