Sheltering Your Retirement Assets From Creditors

By Donald Jay Korn
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With jury awards ever-increasing and malpractice coverage dwindling in many states, many physicians are anxious about credit protection. Moreover, malpractice lawsuits are not only threat to your wealth. "The potential liability risks to physicians include claims of Medicare fraud, actions that grow out of sitting on various hospital committees and boards, business partner disputes, charges by disgruntled employees, divorce and damages from accidents," says Dr. J., a family physician in Kentucky.

If you wind up on the wrong end of a damages award, your creditors naturally will want to seize your assets. As a doctor, a tax-deferred retirement plan may be your most valuable asset, or among the most valuable. Therefore, protecting your retirement plan from creditors might be critical to your financial well-being.

Fortunately, here is some good news in that area. "Under ERISA, which is a Federal law, defined contribution and defined benefit plans are protected from creditors in bankruptcy actions," says Nick M., an attorney of counsel in Connecticut, who is also the author of Safe Harbors: The Asset Protection Guide for Small Business Owners. "Almost all states extend this protection to their own courts, in civil actions."

This protection may be powerful, indeed. In one case, a California physician who operated his practice as a corporation filed for bankruptcy. "The physician had accumulated nearly $2 million in a retirement plan," says Mr. M., "California, like many other states, exempts assets in a retirement plan from liquidation."

The physician's creditors challenge the $2 million exemption on the grounds that it was unfair. "The court agreed with the creditors that the exemption was unfair," says Mr. M., "but the court found that it was powerless to ignore the exemption. As a result, the physician eliminated all of his debts and walked away from bankruptcy with $2 million."

"Had he withdrawn that $2 million from the corporation and invested it in a personal portfolio outside of a retirement plan, he would have lost the $2 million."

Such court decisions might lead you to expect that your retirement plan is safe from creditors, but that may not be the case. "For one thing," says Mr. M., "a retirement plan is not protected under ERISA if it covers only owners and spouses. You need other participating employees."

Thus, a retirement plan that covers only you and your spouse won't be sheltered from creditors by ERISA. Similarly, if a number of physicians are all shareholders in a group practice, with or without spouses, retirement plan assets won't be protected by ERISA unless other employees also participate.

Such plans are considered to be "non-ERISA" plans, in the language of asset protection specialists. IRAs, Roth IRAs and SEP-IRAs also are non-ERISA plans. What about SIMPLE IRAs, an increasingly popular plan that was created a few years ago? "That's a gray area," says Mr. M. "If asset protection is a key concern, you're probably better off with a SIMPLE 401 (k) plan, even though more paperwork will be involved. You should have employees other than your spouse participate in your SIMPLE 401 (k), too."

What kind of asset protection do you have with non-ERISA plans? "That's a function of state law," says Mr. M. "Each state has its own rules, providing more or less asset protection.

Before you spend thousands of dollars on sophisticated asset-protection strategies, speak to a local attorney to determine how much exposure you really have. What's more, different types of retirement plans may have varying levels of asset protection, within one state."

In many states, owners of IRAs and other non-ERISA plans area allowed to protect what's "reasonably necessary" for the support of the debtor and the debtor's dependents. This will be a subjective judgement, determined by the courts on a case-by-case basis. What is considered to be reasonably necessary might be determined by factors such as your present and anticipated living expenses, present and anticipated income from all sources, your age and ages of your dependents, and so on. A substantial amount of your retirement assets might be sheltered – or most of the money in your account might be awarded to a creditor.

"The bottom line," says Mr. M., "is that you should know what rules are in your state. If your state does not have strong assets protection for IRAs, you might want to keep your retirement assets inside an IRA plan instead of rolling money into an IRA. If you're thinking of relocating to another state, find out about the new state's asset-protection rules."

These rules are evolving, so you should check with a knowledgeable attorney from time to time, to see if there have been new developments. "However," says Mr. M., "if your assets are being threatened, moving to a state that will protect those assets might be considered fraudulent." The principle of "fraudulent conveyance" applies to retirement plans. That is, if you make a move with the intent of moving assets out of the reach of known or likely creditors, that move may be disregarded by a court, exposing those assets to your creditors.

Preventive Measures

Before your retirement assets are threatened, though, you might want to take preventive measures. Dr. Gibson, who has an asset protection consulting company as well as a medical practice, reports that she is looking into the possibility of sheltering retirement assets via a Nevada corporation. "The main purpose of using a Nevada corporation for asset protection is to hold real estate," she says. "A Nevada corporation allows you to maintain anonymity, which is necessary. If a judge can find it, he can seize it."

Mr. Rosen says that physicians who are truly concerned about asset protection can have their retirement plan establish a single-member offshore limited liability company (LLC) in a jurisdiction such as Nevada. "The retirement plan can transfer its assets to the LLC in exchange for 100 percent ownership of the LLC. You manage the LLC, so you'd have control over the retirement assets."

As long as your assets aren't threatened, the retirement assets (now the LLC assets) can be held at the same U.S. financial institutions, managed by the same investment advisors, while you make ongoing contributions. "If an employee retires," says Mr. Rosen, "the LLC can make the necessary payments. Life goes on."

If a problem arises, though, you may want to act. If a creditor tries to reach your retirement-plan assets, says Mr. Rosen, "the LLC assets can be transferred offshore, perhaps to an asset-protection trust. Proper safeguards should be in place (such as offshore trustee the funds. Also, the funds should be held in a financial institution without any branch in the U.S., so a U.S. court won't be able to pressure that institution."

Setting up such barriers may discourage a creditor from going after your retirement plan. However, this protection is not inexpensive: Mr. Rosen puts the expected costs of creating such a plan at $25,000, plus ongoing administrative costs. "You probably would not want to spend this much if your retirement plan has a modest amount in it," he says, "but it might be worthwhile for a large plan."

Not every physician will want to spend tens of thousands of dollars, setting up an offshore escape hatch for a retirement plan. Before considering such an action, you probably should take a hard look at the laws in your state and how they have been enforced. Speak to a local attorney to determine how much exposure you really have. You may wind up being confident that your retirement assets are safe in an employer-sponsored retirement plan, or in an IRA.

On the other hand, you might discover that your retirement plan lacks protection, or that the local courts are hostile. If you have a sizeable amount at stake, you may decide that it's worth spending the money.