



## Protecting Your Home From Lawsuit Risk

By Robert J. Mintz, Esq.



The family home represents most people's largest source of wealth and personal savings. In many parts of the country, dramatic increases in housing prices have made real estate the new investment of choice over the stock market and other traditional vehicles. Many people have built up substantial equity in their residences. What can be done to protect these valuable properties from the risks of a potential lawsuit? In previous articles, I broadly described some of the popular strategies used for asset protection such as different types of trusts, family limited partnerships, and limited liability companies. This article will discuss several strategies that can be implemented to protect the family home from lawsuit risks. It is important to remember that a residence is treated differently for asset protection and tax purposes than a rental property, so in this article we will focus solely on the family home. The next article in this series will deal specifically with the protection of rental properties.

### Unique Considerations

The primary family residence is associated with certain unique legal attributes, including a distinct set of tax and legal considerations, which do not apply to any other type of property. Rental real estate has its own characteristics, and savings and pension are treated still differently. In light of this, several key factors must be considered when devising a plan to protect the home from liability risk.

### Tax Benefits

There are strong tax advantages associated with home ownership. While you are living there you are entitled to a mortgage interest deduction, and when you sell you can exclude up to \$500,000 of gain (for a married couple). The requirement for tax purposes is that you are the owner of the residence. If you and your advisor create a plan that removes you from ownership, these tax benefits could be jeopardized. So, care must be exercised in the plan-

ning stages to choose the appropriate strategy to avoid inadvertently losing the available tax advantages.

### Property Taxes

A number of states prohibit a local property tax reassessment as long as you own your home. For example, California does not allow a reassessment to a higher value unless there has been a change of ownership of the house. This law prevents the county assessor from raising property taxes every year when the house increases in value, an important consideration in light of the hyperactive housing market in California and other places. People who bought their homes many years ago—say for \$100,000—would not be able to afford to pay property taxes based on a new valuation of \$1 million. California and other states prohibit a change in the property taxes unless the house is sold or there is some other "change in ownership," which can include a transfer to a trust or other entity. If your state law

protects you from these increased taxes, any strategy for protecting your home must avoid triggering a new property tax assessment by carefully following all of the rules.

### *Continued Enjoyment*

It will be important that you maintain the ability to live in your home even after it has been incorporated into the asset protection plan. The situation is a little different with rental real estate or retirement savings that you may not need to use until some time in the future. Clearly, you need to live in your home now, but you don't necessarily need to use the income from your investments while you are working. There is no question about it, when dealing with an asset that is reserved for current use, protection of that property is more difficult and requires considerably more thought and planning.

### *Homestead Protection*

Depending upon the state where you live, certain legal protections for your home already exist. Each state has laws that exempt from a judgment a specific amount of equity in one's home. For example, in New York the homestead exemption is only \$10,000 for an individual, and in California this amount is \$50,000. Massachusetts has one of the higher explicitly exempted amounts—\$300,000. Florida and Texas go the furthest and provide actual protection for an unlimited amount of equity. Any amount of home equity—even millions of dollars—is protected from seizure by a creditor. The impact of these laws is such that if the amount of the equity in your home is clearly protected under the laws of your state, then no further planning may be necessary. Further legal protection is necessary only if you have equity that exceeds the amount protected by state homestead laws.

### **Plans That Don't Work**

As I mentioned above, techniques

that can be used to protect other types of assets, such as investment real estate and savings, are generally not effective for protecting the family residence. For example, if the home is incorporated into a family limited partnership (FLP) or limited liability company (for more on these subjects visit [www.mdng.com/departments/mar\\_apr2004/assets.htm](http://www.mdng.com/departments/mar_apr2004/assets.htm), with additional information at [www.rjmintz.com/appch5.html](http://www.rjmintz.com/appch5.html)), the IRS has ruled that some or all of the tax advantages described above may be lost. In addition, if a property within an FLP is reserved for personal use, the protection offered by the FLP could be vulnerable to challenge in a future lawsuit. The traditional strategy of simply gifting the home to your spouse will preserve the tax benefits but is unlikely to accomplish anything in terms of asset protection (see [www.rjmintz.com/gifting-equal-division.html](http://www.rjmintz.com/gifting-equal-division.html) for more on this).

### **Solving the Protection Problem**

With this information in mind, the question that must be addressed by an asset protection plan is how to protect equity, above the homestead exemption, while preserving the tax benefits and the continued right to use and enjoy the house.

First, let's tackle the tax issues. Some trusts are treated by tax law as if they do not exist. This type of trust is known as a "grantor trust," and if care is not taken and improper language is used in the trust document, the IRS will treat you as the owner of the property, not the trust. That's good and is what we want for our (tax) purposes. The goal is to create a legal trust that is respected for protection purposes but that is ignored for taxes, thus assuring the retention of all the tax benefits. So, the first requirement for devising a plan that protects the family home is to incorporate a trust that is treated as a "grantor trust."

Once the tax-related aspects of devising a plan for the home have been addressed, you should consider the asset protection issues. To achieve worthwhile protection for the residence, it is important that your legal rights concerning the house are limited in some manner. If you maintain the full spectrum of ownership rights, it is likely that a judge would order you to turn over the property to a plaintiff in the event of a judgment against you. In other words, to the extent that you have unrestricted power to do anything you want with your home, it can be seized in a collection action. The key to protecting your home is to limit your rights in some manner so that there is nothing legally available that can be reached. If your ownership of your home changes from full and complete to something less, your interest may have no value to a prospective creditor. Of course, you could fully protect your home by giving it away to your children and not living there anymore. That would achieve perfect asset protection, but in most cases it would not be a satisfactory solution if the goal is to retain the home as your primary residence. How can you limit your rights in an acceptable manner?

### **Personal Residence Trust**

One solution might be the use of a Personal Residence Trust. A Personal Residence Trust (PRT) is a broad generic term we apply to a trust designed to hold property and apply restrictions that protect it against possible loss. This type of trust is designed to be ignored for tax purposes so that no tax issues are created and the tax benefits are preserved. There are many different formats and strategies that can be used when creating this type of trust, depending upon the particular circumstances of the case.

One popular technique is to provide

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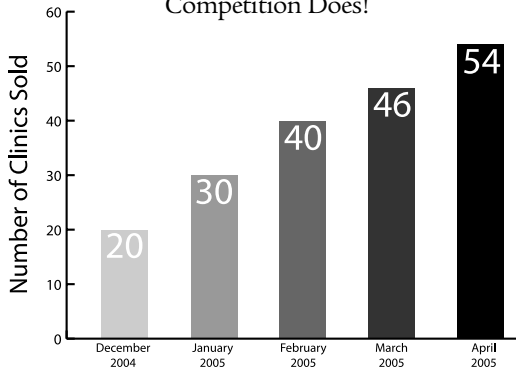
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## covering your assets

### PRIMARY CARE

in the PRT that your children or other family members take ownership of the house after a certain number of years. The trust reserves to you the right to live there for a period of time, perhaps 10 or 20 years. In addition to powerful asset protection advantages of this arrangement, depending on the exact terms contained in the trust, may also provide excellent estate tax benefits by freezing the value of the house at its current amount and removing it from your taxable estate. The period of years and other important terms can be modified or tailored to meet most circumstances.

It may also be beneficial to reverse this arrangement if the circumstances are appropriate. Rather than reserving a right to live in the home for a period of years, the PRT can provide that the home belongs to the trust but can be leased back to you for a period of years. Although you would pay rent to the trust, the usual tax benefits would still apply because of the grantor trust rules. At the end of the term of the lease, full ownership could be returned to you or passed to your children. It can go either way, depending upon your view of any future potential liability you may have.

In a slightly different vein, the PRT could be provided with an option to purchase or a right to exercise some other authority over the property within the trust. For example, let's say your home is worth \$1 million with a loan of \$500,000. You could create a PRT that grants the trust an option to purchase the property for the loan amount at any time within the next 15 years. The option agreement would be recorded and act the same as a lien on the property. The equity in the home could not be seized by a successful plaintiff, since the home itself is subject to the option to purchase for the \$500,000 amount. Under this arrangement, you could live in the house without restriction and subject only to whatever terms are provided in the option agreement. There are a number of issues that must also be addressed in this type of strategy, but this illustration gives you an idea of the kinds of things that can be incorporated into an asset protection plan.

### Closing Argument

Protecting the family home from the risk of lawsuits requires consideration of income tax and local property tax issues as well as your state's homestead law. A Personal Residence Trust may provide a good solution for many of the potentially complicated issues that typically arise when devising an asset protection plan designed to protect a family home. For those who feel that they have some degree of lawsuit exposure and who have substantial equity in their home, one or more of the available strategies with the Personal Residence Trust may be a conservative course of action. You should always discuss the particular circumstances of your case with your personal legal advisor in order to develop an appropriate asset protection plan.

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