Protective Devices

There are many ways clients can shield their assets or business, but choosing the right form is critical.

By Roccy DeFrancesco

LAST MONTH, IN THE FIRST PART OF this series on asset protection, I discussed the reasons why high-net-worth clients (especially professionals who provide services, like doctors, lawyers, and even financial advisers) need asset protection and how asset protection can be accomplished using existing laws. This article will focus on the use of limited liability companies and family limited partnerships as useful tools for asset protection. I will also briefly discuss the role of offshore asset protection tools and trusts for clients.

Most people think that great asset protection comes through the use of "corporations." What most clients don't realize, however, is that there are several different types of corporations and limited liability companies. Depending on which entity is chosen, both the asset protection and tax consequences could be different. Let's start with the types of corporations to avoid.

Sole proprietorship. This is the second worst way to own or run a small business (you will see what's worse in a few minutes). A sole proprietorship exists when an individual operates a business without filing to have that business recognized as a legal corporate entity.

With a sole proprietorship, there are no barriers between the business done and the individual who owns the business. Why is this bad? If a sole proprietor acting on behalf of her business commits negligence in her duties for the business that causes injury to a third person, the sole proprietor is then personally liable for any and all injuries to that third person. There is no reason for a client ever to be a sole proprietorship.

Partnership. Partnerships are the worst entity clients could possibly be involved in from an asset protection standpoint. With a partnership, clients get all of the headaches and personal liability of a sole proprietorship, with the additional twist of having a partner who can cause them even more liability.

In a partnership, each partner is liable for all the actions and debts of the other partners (as they relate to the business). If one partner takes out a loan on behalf of the partnership, even without the permission of the other partners, all partners are on the hook. This also includes scenarios involving individual actions. For example, if one partner sexually harasses an employee and the business gets sued for sexual harassment, the suit is against the partnership, and all partners have personal liability. Never allow your clients to be a partnership.

Corporation. Businesses incorporate mainly to avoid any personal liability for the negligent actions of the corporation. This includes limited liability of the corporate shareholders as well as individual liability of the employees of the company (if they are acting within the scope of employment).

There is one important exception to the limited liability that goes along with corporations, however. That's in the area of personal services. Personal service liabilities include work that's done for or on behalf of clients by doctors, attorneys, accountants, and financial planners. The exception means that a physician who treats or operates on a patient can't hide behind the corporate veil that normally provides limited liability for owners and employees working in the normal course of business. If a patient sues for malpractice, the physician is named individually, because the personal liability cannot be removed by incorporating.

Now let's look at the best tools to use for asset protection—limited liability companies (LLCs), family limited liability companies (FLLCs), and family limited partnerships (FLPs). In this article, I will use LLC interchangeably as a term that stands for all three entities. For asset protection purposes, each entity works in the same way.

Briefly, LLCs were designed to bring together a single business organization containing the best features of the pass-through income tax treatment of a partnership and the limited liability of owners in a corporation. LLCs also provide the standard corporate protection to all shareholders and directors for any negligence actions against the LLC itself.

LLCs are treated the same from a corporate liability standpoint as S- or C-corporations. Doctors, for instance, still have personal liability if they commit malpractice and a patient sues. But there is a major difference between an LLC and a corporation that relates to asset protection. This difference involves the role of a so-called charging order.

A charging order is typically the only remedy a court of law can give to a creditor who is trying to get the assets of a debtor when the assets are in an LLC or limited partnership. A charging order doesn't allow creditors to sell the assets of the LLC or force any distributions of income. The best way to illustrate what a charging order does is to use an example. (Always check your state statutes to ensure that there have been no recent changes in the law.)

Assume that Patient Lucky sues and obtains a judgment against Dr. Smith for $3 million. Dr. Smith has $1 million in medical malpractice coverage, and all the rest of his major personal assets are in an LLC, which he owns 100%. Lucky asks the court for satisfaction, requesting the court to order Dr. Smith to turn over the assets in his LLC to him. But the court tells Lucky that because the assets are in an LLC, the only remedy it can give to him is a charging order.

What does this charging order get Lucky? Something completely unanticipated and unwanted, no doubt—only the right to pay the taxes on any income generated in the LLC but not distributed (Revenue Ruling 77-173).

So assume that Patient Lucky is able to obtain a charging order against Dr. Smith's LLC, which owns Dr. Smith's $1 million brokerage account and $1 million vacation home in Florida. Further, assume that Dr. Smith earns dividend income of $25,000 a year from the brokerage account and rental income of approximately $20,000 a year. Normally, Dr. Smith takes home the total $45,000 as income from the LLC and invests or spends it as he sees fit.

Beyond financial accounts, many types of assets can be held in LLCs, including rental or vacation property and vehicles like cars and boats.

Because of the charging order, Dr. Smith will leave the income in his LLC at the end of the year, which will subseuqently trigger income taxes due to Patient Lucky. Because Lucky has no desire to pay any taxes on income that he didn't receive, Lucky will immediately release the charging order.

If there is ever a distribution from the LLC, Patient Lucky would get that money, but no creditor wants to continue paying taxes on unreceived income in the sole hope that distributions will be made at some much later date. And virtually no defendant would make any distributions until the charging order is released. The standoff almost always ends with the frustrated creditor dropping the charging order—before the tax bills start coming, of course.

Again, a creditor cannot force distribution of the LLC's assets or income. The power of an LLC is derived from the fact that a creditor can only obtain a charging order against the LLC.

Now look back at what happens in an S- or C-corporation involved in a similar lawsuit. If a client's assets are held in an S- or C-corporation, the judge has a few different remedies to satisfy a creditor's request. First, the court can order a debtor's interest in an S- or C-corporation sold to satisfy the judgment. Second, the court can order the ownership interest of a debtor in an S- or C-corporation transferred to the creditor. Either way, the defendant's assets in a S- or C-corporation can be reached.

There is a potential problem with single-member LLCs in some states. Although these single-member LLCs have been used for some time now, it is usually wise to have another person as at least a 5% owner of an LLC. This setup prevents a creditor from ultimately arguing that an LLC without more than one owner should not be able to hide itself behind a charging order as the sole remedy. If this issue is a concern in your state, then I would suggest that your clients use an FLP, which doesn't have the same potential exposure, or use a Nevada LLC, where the state statute dictates the charging order as the sole remedy for the creditor.

By the way, many types of assets, beyond financial accounts, can be held in LLCs. Real estate—typically a rental or vacation property—is a good candidate. So are vehicles whose involvement in an accident could create liability for other client assets.

For example, a boat worth as little as $10,000 could result in massive costs to the rest of the estate if the owner of the boat drinks and drives and then injures another boater or swimmer. Almost any vehicle can be put into an LLC, including cars, boats, airplanes, waverunners, and snowmobiles.

The decision to put any of these in an LLC is a matter of how much money the client wants to spend and the value

When Creditors Attack

There are two types of creditors who can seek damages from a defendant. For asset protection, it's important to know the difference.

Inside creditors. An inside creditor is one who has as its exclusive remedy the assets of the corporation. Someone who slips and falls on property owned by a corporation can only go after the assets and income of the corporation. This assumes no intentional bad act on behalf of an owner who caused the injury. Most creditors with lawsuits involving negligence of a corporation are inside creditors.

Outside creditors. In addition to going after a corporation's assets, an outside creditor can also go after personal assets of the defendant. For instance, assume that a patient sues a medical practice for a problem allegedly caused by bad advice or a botched surgery. The patient also can sue the physician individually, which puts the doctor's personal assets at risk in this situation.—*RD*

of the assets. Each LLC typically costs between $1,500 and $2,500 to establish it. I usually recommend separate LLCs for assets with significant value.

Almost all clients should be able to achieve asset protection goals domestically by setting up LLCs. However, for certain clients, adding offshore planning may be considered an extra layer of protection. Of course, offshore planning is more expensive and more complex. I'll save the numerous details for a later article, but here are some of the basics on offshore asset protection trusts (not offshore LLCs or offshore captive insurance companies).

First, you should *not* be thinking of these trusts because you heard from a friend or read somewhere that offshore asset protection is the only way to go to protect a client's assets. And you should definitely *not* recommend an offshore asset protection trust if you have any inkling that your clients would save on their federal income tax in the process. If someone tells you or a client that you can move substantial assets offshore and avoid taxes, run the other way.

The asset protection gurus employ offshore asset protection trusts as their main tool. Why? Because even if a client commits fraud when moving his or her assets offshore (for more information on what comprises fraudulent transfers in this country, see "The Prevent Defense" in the August issue of *Financial Planning*), a U.S. court of law won't be able to gain control of the money. Therefore, it will be safe from all creditors.

Technically, the client has no control over the disbursement from the trust. As a result, a U.S. judge cannot demand the client bring the money back to the United States to satisfy a judgment.

If your clients have at least $750,000 or more in a brokerage account, they are getting to the point where the benefits of offshore protection may start to justify the costs, which can be substantial. The legal work can run as much as $20,000 to $30,000 to set up an offshore asset protection trust for a client.

In this short series on asset protection, I have tried to give a summary of several techniques and why one might be more useful than another for clients. The vast majority of your clients are not asset protected, which leaves the door wide open for you to show value to those clients. By bringing up the subject, you will be discussing a topic that has been generally ignored by the client's attorney, accountant, or another financial or insurance adviser. **FP**

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