CHAPTER 1

Introduction

Asset Protection Planning

Business persons have always been concerned about the exposure of their personal assets to claims against their businesses. Certainly, protecting one's assets from the myriad risks involved in business and personal financial planning is not a novel objective or planning idea. The corporate form of business entity, with its shield of limited liability, has been invoked by professionals for centuries to protect those personal resources. Over the last few decades, expanding theories of liability and the proliferation of litigation have given increased emphasis to Asset Protection Planning to the extent that it is now a well-recognized area of practice. It certainly comes within the concept of lifetime Estate Planning—involving the protection and conservation of accumulated wealth or asset base.

Shield of Liability

Business owners, physicians, and real estate investors must always be extremely concerned about potential liability against their personal assets, arising from the operation of the business or ownership of the real estate. Entities such as Corporations, Limited Liability Companies, and Limited Partnerships exist in part to prevent this potential personal liability.

- Corporations are formed to operate businesses and shield the corporate owner from personal liability against creditors of the business.

- Limited Liability Companies (LLCs) and Limited Partnerships (LPs) generally provide the necessary shield of liability for real estate investments; at the same time, they create favorable and flexible tax consequences because they are pass-through entities for income tax purposes.
  - In addition, the potential limitation of the Charging Order remedy to creditors makes LLCs and LPs even more attractive and practical for business operators and real estate owners. (See Chapter 8 for more details regarding the Charging Order remedy.)

NOTE

As our society has become more litigious, assent protection planning has become vitally important to business owners, real estate investors, physicians, and many other professionals.

For clarity's sake, I will present an example of a typical business situation. Richard and his wife, Becky, own a small distribution business. They import products and distribute them on a wholesale basis to retail outlets. They have formed a corporation as the business entity for their distribution and operation. The office and warehouse that houses the distribution business is owned in an LLC, which they also own. The LLC then leases the premises to the distribution corporation. The corporation shield provides protection for Richard and Becky's non-business personal assets: creditors of the corporation can only seek redress from the corporation, and cannot normally attack the personal assets of the couple. The LLC provides protection to Richard and Becky's personal assets with respect to claims against the real estate itself. Richard and Becky were smart to segregate the real estate from the business operations and place the real estate in a separate liability-protected entity. In this way, a claim against the business will not necessarily impact the warehouse and offices inside the LLC. Moreover, a claim against the real estate will not necessarily impact the business operations inside the corporation and cannot normally be asserted against the other personal assets of Richard and Becky.

In June 2014, the US Supreme Court ruled in the case of *Clark v. Ramker* that an IRA (Individual Retirement Account) inherited from another is not a protected "retirement fund" and thus is subject to creditor's claims in bankruptcy. What this means is that unless the beneficiary of an inherited IRA is the resident of a state that specifically exempts inherited IRAs from creditors, such as Alaska, Florida, Missouri, or Texas, the inherited IRA will not be protected from bankruptcy. It may also be that except in those few states, an inherited IRA will also be available to satisfy non-bankruptcy creditors. Accordingly, it is advisable that an individual name a Trust design specifically for the purpose of being the beneficiary of his/her IRA and other retirement plans. The individual can thus ensure that the inherited IRA is protected from creditors regardless of the residence of the beneficiary.

Obviously, Richard and Becky are going to have liability insurance for the corporation and its business operations, as well as for the LLC and the real estate it possesses. However, there is always the danger that the claim is either outside the scope of insurance coverage or that it may exceed the policy limits. On the other hand, the good news is that the corporation will provide substantial protection for Richard and Becky's personal assets against business claims, and the LLC will provide substantial protection for their personal assets for claims against the real estate and the LLC. During the remainder of this chapter and throughout other chapters, we will continue to refer to Richard and Becky's situation (the "Richard and Becky Fact Situation") as a way of better understanding planning techniques, strategies and implementation.

Inside and Outside Creditors

In Asset Protection Planning, creditors are often characterized as either "Inside" or "Outside".

Inside Creditors

Inside Creditors are those creditors whose claims are directed against the business operation or real estate operated and owned inside a separate business entity.

If the entity involved can withstand any piercing attack to its liability veil, then the creditor is limited to remedies against the assets within or inside the entity itself. For example, if a person who falls or slips at an apartment house owned by a properly structured and maintained LLC, that person only has the right to assert the claim against the LLC itself. The members and the managers of the LLC have no personal liability to the Inside Creditor, assuming that the LLC can stand up to any attacks of piercing the liability veil. We will further discuss protecting real estate assets by the utilization of LLCs in Chapter 8.

Most business operations and real estate investments utilizing a corporation or an LLC have liability insurance to protect against Inside Creditors. Business owners and real estate investors should carefully review their liability insurance policies to ensure that their coverage is adequate in both scope and amount. Unfortunately, there are many claims that fall outside of the parameters of the policy either with respect to coverage or policy limits.

As an example of an "Inside Debt" in the Richard and Becky Fact Situation referred to above, if a creditor of the distribution company were to make a claim about a faulty product distributed by Richard and Becky's corporation, that claim should theoretically only be against the corporation itself; Richard and Becky's personal assets and their real estate in the LLC should be protected from that claim. The claim would be an "Inside Debt" in the parlance of Asset Protection Planning, and this separation of assets into different entities would enable Richard and Becky to protect their property. Inside Debts are shielded by proper liability-protected structures.

TIP

Asset Protection Planning needs to account for potential claims against the business or real estate operation and those potential claims directed against the owner personally. The protection structure should be designed to limit personal liability.

Outside Creditors

Outside Creditors are those creditors whose claims are outside of the scope of the business entity and are generally asserted against the business or real estate owner personally. This could happen in the following circumstances:

- In some instances, these claims are closely connected to the business itself. This is the case with many service providers and professionals; they cannot escape personal liability by operating within a liability-protected entity because, as professionals and service providers, they are individually liable for their business-practice-related claims.
  - For example, physicians, lawyers, CPAs, engineers, and architects are personally liable for their malpractice regardless of the fact that they may be doing business in a professional corporation.
- Other examples of claims against individuals that do not come within the protection of the liability-protected entity include liability arising from auto accident claims and other personal (or "tort") claims above and beyond the scope of insurance coverage.
- Other claims may also include breach of contract claims for personal loans, guarantees, and other contractual obligations.

An example of an Outside Debt could be this: in the Richard and Becky Fact Situation, if Richard was at fault in an automobile accident, he would have personal liability which would (hopefully, but not necessarily) be covered by his insurance. If damages exceeded the covered amount, then Richard's creditor would attack both his business assets and his other personal assets for satisfaction of the claim. An alternative scenario would be: if Richard and his business operations encounter financial problems—and Richard and Becky default on a loan they have personally guaranteed—the financial institution would be able to seek redress against them personally. This would then be an "Outside Debt" in Asset Protection parlance.

A Comprehensive Example

In order to better understand the foregoing concepts, another case study will be helpful (though these terms are more specifically explained in subsequent chapters): Scott is a licensed architect with a successful architectural practice. He and his wife, Sophia, own three rental properties, and Scott has a limited partnership interest in the LP that owns the building where his offices are located. Scott interacts with several other professionals in the building in the course of providing his services. Scott and Sophia are the parents of three minor children, but have only taken a few basic Estate Planning steps. Obviously, because of the three minor children, Scott and Sophia are very concerned about Estate and Asset Protection Planning. They realize that not only are they at risk as a couple, but the three children are also substantially at risk because of their dependence on Scott and Sophia. What are some of the problems Scott and Sophia face? Here are several of the most important items they need to address:

1. Scott's Architectural Practice and the Ramifications of Operating as the Sole Proprietor

Because Scott interacts with other professionals, he should probably think of incorporating his practice. Although the incorporation will not provide a complete shield against his malpractice liability, it will help to protect Scott against potential liability of his associates and other building providers. This is the first level of protection every business owner and professional should address. We will discuss this area as the first step of The Ladder of Success in Chapter 5.

2. Estate Planning

Scott and Sophia should address some basic Estate Planning needs. They own several assets, and should anything happen to either one of them, they would need Wills with executors and guardians for their children. They need a Living Trust for their residence and other assets. They need Healthcare Powers of Attorney, Durable Powers of Attorney and other basic Estate Planning documents. These will be addressed in Chapter 6.

3. Exemption and Marital Planning

Scott and Sophia should examine different creditor exemptions and title their property in the manner most likely to provide Asset Protection. This may involve some Marital Planning and Marital Settlement Agreements that will be discussed in more detail in Chapter 7.

4. Liability-Protected Entities

Scott and Sophia own rental properties that can be exposed to claims either outside the scope of insurance coverage or beyond the insurance limits. Accordingly, Scott and Sophia should strongly consider placing these rental properties in LLCs to limit the liability to the property itself. This area will be discussed in more detail in Chapter 8 as Step Four of The Ladder of Success.

5. Domestic Asset Protection Trusts

Next, Scott and Sophia should definitely consider setting up a Domestic Asset Protection Trust. The combination of this Trust with the LLC Member Interest can provide superior protection against creditors' claims. This will be discussed in Chapter 9.

6. Offshore Planning

If Scott and Sophia have the inclination and the necessary liquidity, they might consider Offshore Asset Protection Trusts. This is, perhaps, the ultimate form of Asset Protection Planning for most individuals. However, going offshore is not for everybody. There are significant benefits, but the offshore experience is generally limited to those individuals who have substantial liquidity that can be placed offshore and/or have international connections of some form or another. This will be discussed in more detail in Chapter 10.

7. Advanced Estate Planning

Finally, there may be some advanced Estate Planning techniques that Scott and Sophia should consider. These include, but are not limited to, the following:

- The Irrevocable Life Insurance Trust (ILIT)
- The Grantor Retain Annuity Trust (GRAT)
- Sales to an Intentionally Defective Grantor Trust
- The Qualified Personal Residence Trust (QPRT)

These techniques will be discussed in Chapter 11.

8. Just What the Doctor Ordered

In Chapter 12, I have provided some special techniques and strategies for physicians and dentists. These service professionals face unique challenges and have their own particular issues as healthcare providers. All the other chapters in this book are also relevant to physicians and dentists; several of the case studies included throughout the book involve physicians. Chapter 12, however, specifically addresses physicians and dentists and their unique needs and requirements for Asset Protection Planning Services.

9. Putting It All Together

In Chapter 13, we will put it all together. We will give several case studies and explain how different tax situations can be analyzed and how design plans can be strategically developed to meet the needs and objectives of the individuals involved.