Asset Protection: The Business Owner's Safeguard

Anyone, at anytime, can be sued for a substantial amount of money, but you can safeguard your assets with a comprehensive asset protection plan. Asset protection planning involves applying lawful techniques that protect your assets from lawsuits and claims of future creditors. Additionally, while estate planning usually involves issues associated with preserving and passing property at death, asset protection techniques address the immediate need to protect assets during your lifetime. Asset protection planning often includes establishing a series of trusts, partnerships and entities to hold legal title to your assets.

Implementing various asset protection techniques protects your assets by creating layers of protection to frustrate and discourage potential creditor's attempts to seize your assets. The general idea underlying asset protection is that a creditor can reach virtually any asset owned by a debtor, but cannot reach assets not owned by the debtor. Once a creditor determines that your assets are actually owned by various entities, and not you as an individual, the right to a potential claim is often outweighed by the expense and time associated with going forward with any legal action. Therefore, the focus of all asset protection planning is to remove the debtor from legal ownership of assets while retaining the debtor's control over and beneficial enjoyment of the assets.

It is important to note, however, that if you transfer property with the intent to defraud existing creditors, the transfers will not be successful. Moreover, a transfer of assets to hinder or delay your existing creditor's collecting efforts can be voided. Therefore, it is important to implement a proper asset protection plan based on your assessable liability exposure well before a lawsuit or creditor claim arises. Your degree of exposure to potential liability, the types of assets you own, and your total net worth are essential factors to consider when developing a comprehensive asset protection plan.

Family Limited Partnerships

While family limited partnerships ("FLP") are probably best known for the valuation discounts available when valuing an undivided interest in an FLP for federal gift and estate tax purposes, FLPs can also be used to protect assets from lawsuits and creditor claims. Otherwise attractive and valuable assets to a creditor are made less so when they are transferred to, and held by, a FLP. Assuming the partners have respected the FLP as a separate and distinct legal entity separate from themselves, a creditor of one or more partners will be unable to reach partnership assets to satisfy its claim against any of its partners since the assets of the partnership are owned by the partnership, not the individual partners. Additionally, should the creditor attempt to instead seize the debtor partners' interest in the FLP, the "charging order" limitation found in virtually all state limited partnership laws will likewise frustrate a creditor's efforts.

The charging order evolved as a way to divert the debtor's share of the partnership profits and surplus to his creditors without disrupting the ongoing partnership. Generally, the partnership interest cannot be seized or sold, unlike other non-exempt personal assets. Instead, the charging creditor becomes a mere assignee of the judgment debtor with respect to his partnership interest. State law generally accords an assignee of a partnership interest little or no rights other than the right to receive distributions made with respect to the "charged" interest. The charging order operates, in effect, as a substitution for execution on a partner's interest in the limited partnership interest. As an assignee, a creditor has the right to receive distributions to which the debtor partner would have been entitled; however, the charging order does not entitle the creditor to become or to exercise any rights of a partner. As an assignee of a partnership interest, the creditor may not become a limited partner unless all other partners consent, something unlikely to occur. Thus, it is unlikely that the general partner would elect to make a cash distribution to partners which would entitle the creditor/assignee to a distribution.

The FLP can be amended to respond to changing business, family and legal needs. This flexibility allows the FLP to be drafted to facilitate the preservation and orderly transition of family wealth and managerial control from one generation to the next while protecting your assets.

Limited Liability Companies

Notwithstanding the popularity of FLPs, the use and popularity of the limited liability company structure within asset protection plans has increased. A limited liability company ("LLC") is a legal entity that provides the benefits of liability protection usually associated with corporations, but without the need to pay corporate taxes and without the strict formalities of corporate minutes, bylaws, directors, and shareholders. A properly structured LLC can provide a liability shield for its members as well as pass-through tax benefits. The law effectively insulates the owners of the LLC from any liability produced by the business. Therefore, personal assets are not subjected to the risks of a business operated within the LLC.

Members of an LLC are neither co-owners of, nor have a transferable interest in, property of an LLC. Thus assets transferred to an LLC become the property of the LLC and not subject to the creditor claims of its individual members. Since a creditor's recourse against a member is limited to a charging order, assets transferred to an LLC can be effectively protected against levy and seizure by a creditor.

Additionally, a recent IRS Chief Counsel advisory held that the IRS may not levy on the assets of a single member LLC in order to satisfy the individual tax liability of the sole member-owner. [1] The mere fact that the entity may be disregarded as a separate entity under IRS regulations does not legally justify an IRS levy on the assets of the LLC since property rights in those assets are governed under state law. Since state law provides that when assets sought to be levied upon are the property of the LLC and not the individual member, the individual taxpayer-member does not have a property interest in those assets that the IRS can levy upon. The IRS, nevertheless, has other collection options available including a levy against distributions from the LLC to the individual member; however, even the IRS must wait until those distributions are made.

Protective Language in Partnership Agreements and Operating Agreements

There are significant benefits associated with including protective language in the FLP's partnership agreement or LLC's operating agreement. The agreement will be binding upon assignees of a partner/member. This includes creditors who obtain a charging order on the partnership or membership interest of a partner/member. A properly drafted agreement should provide that the partnership/membership or partners/members who are not affected by the creditor action would have the option to purchase the interest of a partner/member whose interest is subjected to a charging order. The agreement can also provide that the purchase price shall be payable over an extended term of years at a favorable interest rate.

In addition to incorporating the right to purchase the interest of the charged partner/member, the agreement should provide for a quick, simplified, and favorable method of valuing the interest of the charged partner/member. One method of accomplishing this is to provide for mandatory mediation and binding arbitration of any valuation dispute. The agreement can also go so far as to provide for the selection of arbitrators that are familiar with the proper valuation of a limited partnership interest in a FLP or membership interest in an LLC.

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[1] Please note that a recent U.S. bankruptcy court held that a sole member's Chapter 7 bankruptcy filing effectively assigned her entire membership interest in the LLC to the bankruptcy estate, and that the trustee thereby obtained all of the debtor's rights, including the right to control the LLC management. The court admitted that, under applicable law, the result would have been different had there been other non-debtor members in the debtor LLC. In Re Albright, 291 B.R. 558; (Bankr. D. Colo. 2003); 11 USCS §541 (2007).

Multiple Entities

Putting all of your assets in a limited liability entity such as an LLC can provide personal liability protection to the owner of that business with an important exception. If the owner is responsible for the event leading to the liability, the fact that the company is a limited liability entity doesn't protect the owner from personal liability. Additionally, there is little asset protection for the owner if a creditor is successful in its action against the company. Since the bulk of most business owners' wealth is in the assets of their companies, a successful creditor attack against the company will wipe out the majority of most owners' wealth by wiping out the value of the ownership interest in the business.

One solution is to create multiple entities to implement multiple buffers to your assets. If one entity is attacked successfully by creditors, its assets will disappear. But, if properly planned, the bulk of the overall assets, contained in the other entities, will survive intact.

Example

Steve owned several retail locations, each with its own exposure to operational liabilities such as employee-based lawsuits or customer-based lawsuits – imagine for a moment a scenario where numerous customers of one location contract food poisoning.

By creating a separate legal entity for each location, the liabilities of that location will more likely be confined to the assets of the particular location and entity. Had Steve owned a business with just one location, his ownership interests would be better protected if he separated the real estate (or perhaps the equipment used in the business) from the operations.

One common suggestion is to transfer the real estate used by the business into an LLC owned solely by Steve and his family and the operations in a separate entity such as an S Corporation or LLC. Once again, valuable assets, such as the real estate, will tend to be protected from the liabilities of the business operation, and even, to the extent the LLC is owned by others, from Steve's personal creditors.

Asset Protection Trusts

Trusts can be an important tool in your asset protection planning. Many trusts that you might consider using to meet tax, financial, personal or other goals can have important asset protection benefits as well.

Spendthrift Trust (also known as Credit Shelter Trust)

One of the most common types of trusts used in asset preservation is a spendthrift trust. A spendthrift trust, by its terms, provides that a beneficiary in the income or principal of the trust may not be voluntarily or involuntarily transferred or otherwise alienated by the beneficiary, except as provided by the trust instrument. The legality of the spendthrift trust is recognized in virtually all states.

A discretionary spendthrift trust - in which the trustee has sole and absolute "discretion" to decide the amount and timing of income or principal distributions to the beneficiary - provides even greater protection to its beneficiaries than a spendthrift trust, which calls for specified distributions. Further, the broad discretionary powers of a trustee under an agreement which empowers the trustee full and absolute discretion in making distributions to beneficiaries constitutes a further restraint upon the ability of the beneficiaries of the trust to assign or in any manner alienate the income or the principal of the trust, and represents as well a further immunity. The courts will generally not extend a creditor's reach to income of discretionary trust funds, which are held in trust for the ordinary and necessary living expenses of the beneficiary, at least until such funds are actually received and held by the beneficiary.

Qualified Personal Residence Trust

An FLP or LLC cannot be used to protect the family home. The tax advantages you are permitted for your home, such as the mortgage interest deduction and the exclusion from tax of $250,000 in gains per spouse, are not allowed under the rules governing an FLP or LLC. One alternative to address this issue is a Qualified Personal Residence Trust (“QPRT”).

A QPRT is a grantor-type trust, specifically permitted under the Internal Revenue Code, where protection against claims is afforded while the tax benefits of ownership are preserved. A strong degree of control and enjoyment over your home can be maintained, depending upon the terms of the QPRT which you establish. Most states protect some or even all of the equity in your residence with a "Homestead Exemption." Depending upon where you live, a specified amount is sheltered from a creditor's claim. In Florida, Texas, and Kansas, the amount is unlimited; almost any amount can be protected in the equity of the home. Other states range from $20,000 to $300,000. Depending upon the particulars of the law in your state, you may identify a need to protect equity over the homestead amount.

Foreign Trusts and Foreign LLC's

Those in the high-risk medical specialties and those for whom insurance coverage is unavailable or inadequate can enhance their asset protection plan with a foreign trust or foreign LLC. Although there are some technical and practical distinctions in the way each operates, the underlying premise of both is similar: prospective plaintiffs and their attorneys may be discouraged from even filing a case if collection of a judgment appears difficult or impossible. Moreover, a foreign trust or foreign LLC can force a plaintiff to litigate in an "unfriendly" foreign jurisdiction with laws designed to support common asset protection goals.

The ability to move funds out of the jurisdiction of the US court system may be a powerful weapon in litigation, but there are certainly limitations, costs, complexities, security issues and risks of using these trusts that must be considered before proceeding. Additionally, foreign trusts, like any other single tool, are never the entire solution. They are best implemented along with other appropriate domestic asset protection techniques.