

Chapter 24

PROTECTING YOUR ASSETS

Practice and business owners pay much attention to and spend much of their time building their practices and businesses in an effort to obtain and accumulate wealth. The same individuals often spend little time or give little thought to the protection of assets, once acquired.

Asset protection planning is essentially the process of organizing your and your spouse's assets (including business and practice interests) in advance in order to guard them from loss by reason of some financial disaster in the future. The concept of asset protection planning applies to all types of assets. However, negative consequences can result from not planning to protect assets prior to the existence of a significant financial problem, as there may exist creditors who are entitled to remedies under the fraudulent conveyance laws of your state. Therefore, if an asset protection plan is implemented, it should be for legitimate business purposes and not used as a means to hide assets from creditors.

In recent years, our society has evolved to a point where persons with wealth must plan to protect assets or risk losing them as a result of a financial calamity from potential lawsuits. With over 100 million state court lawsuits filed each year, the importance of protecting your wealth should not be overlooked.

Asset Protection Planning Goals

The goals of any asset protection plan will vary with each person as every person's financial situation is different. However, here are some common objectives.

First, asset protection plans which are designed with a conglomeration of entities will confuse and frustrate you. A properly designed structure which functions because of its sound legal principles is more protective than one which is overly complicated.

Second, asset protection planning can deter potential litigation by reducing the value of the assets. Therefore, a properly designed asset protection plan can provide an incentive to creditors to settle inexpensively. Alternatively, where an asset protection plan is not in effect, a plaintiff or creditor will not have any roadblocks to contend with in court.

Third, the proper implementation of an asset protection plan can enhance your bargaining position and posture throughout the course of litigation.

Fourth, a properly structured asset protection plan will not lock you into a course of action which must be followed regardless of what happens, but should provide you with certain options that would not otherwise exist.

Fifth, an asset protection plan will create an economic cost to a potential plaintiff or creditor.

Finally, an asset protection plan should be designed to ultimately protect you against any potential adversary. For example, you may have a concern over the possibility of a malpractice claim being filed in the future against you or your partner. Also, another situation or problem could develop through a business dispute with a partner or co-owner or from the termination of an employee. Therefore, the asset protection plan should provide protection of your assets from a multitude of potential threats.

Pitfalls In Asset Protection Planning

An asset protection plan should not be premised upon hiding assets, which can create serious problems. Additionally, an asset protection plan is not an excuse to defraud creditors. Although there exists uncertainty as to when asset protection planning can be implemented and to the extent, the successful situations are those where the planning is completed at a point in time where you do not have pending or threatened claims against you. For example, where an individual is about to file for bankruptcy, the assets which were transferred pursuant to the asset protection plan could be attacked by creditors through the fraudulent conveyance laws of the state where the transfer took place. Fraudulent conveyance laws vary by state and there exist certain fraudulent conveyance laws at the federal level as well. Therefore, the asset protection plan should be implemented in accordance with the applicable fraudulent conveyance laws, which focus on the intent and timing of the transfer of the assets.

The fraudulent conveyance laws provide that where a debtor makes a "tainted" transfer to another person or entity, a court can set aside the transfer as if it never occurred. There are two types of tainted transfers. If a debtor makes a transfer with intent to hinder, delay or defraud creditors, it is deemed a tainted transfer. For example, if you are sued on Monday and on Tuesday you transfer all your assets to your spouse, the transfer would be deemed a tainted transfer.

The second category of tainted transfers involves transfers for less than fair consideration, e.g., a gift, where the transfer renders the debtor insolvent. For example, this situation would occur where you would make a gift of all your assets to your children so that after the transfer your personal net worth would be negative.

The timing of the transfer is an important planning issue with respect to the fraudulent conveyance laws. The longer the time period between the lawsuit and the transfer the better. A long history of gift-giving pursuant to a business or estate plan may also be helpful in these situations.

Asset protection planning is not an excuse for the evasion of federal income or estate taxes. Although some wealthy individuals and their advisors are attracted to asset protection planning by the tax advantages they hope to achieve, generally a well designed asset protection plan should be tax neutral. Although tax planning may be an important issue with respect to business and practice planning or estate planning at the individual level, tax planning may or may not coincide with the goals of the asset protection plan. However, if you presently have assets titled in your name and desire to transfer these assets to your spouse, a trust, limited liability company or a family limited partnership, you should be sensitive to potential gift and estate tax consequences resulting from any transfer.

As to foreign trusts or entities, what may appear to be a tax loophole may not really be what it seems. Additionally, where an asset protection plan uses foreign trusts or entities, you run a substantial risk that your assets may be confiscated at some future date through events beyond your control, e.g., change in power in a formerly friendly county, etc.

Asset Protection Planning

In application, asset protection plans can be of assistance to you in a variety of circumstances as follows.

- (1) As a supplement (not as a replacement) to malpractice insurance;
- (2) To cover a lapse in insurance;
- (3) To provide backup insurance in the event that your insurance carrier fails, goes out of business or does not have the economic means to pay your claim(s);
- (4) As a protective device against the risks associated without outside business activities from your profession;
- (5) As a means to allow you to recover from previous economic problems;
- (6) As a means to reduce susceptibility from potential lawsuits;
- (7) As a supplement to a prenuptial agreement;
- (8) As a means to reduce the value of assets subjected to risk in the event that you sign personally for a loan;
- (9) As a means to protect retirement plan assets where such plan assets are not absolutely protected from creditors, e.g., IRAs in some cases;
- (10) As a means of enhancing and coordinating the estate planning process;
- (11) As a means to provide leverage in negotiations with creditors;
- (12) As a means to protect inheritances (e.g., from young or incapacitated beneficiaries);
- (13) As a means of protecting proceeds from the sale of your practice or business; and
- (14) As a means to protect you from Superfund liability (environmental liability) regarding the ownership of real estate.

Methods of Asset Protection Planning

Generally, asset protection planning consists of the following issues: (i) use of insurance; (ii) entity selection; (iii) how title to assets are held; and (iv) the protection of retirement plan assets from creditors.

Use of Insurance. Every practice and business owner needs insurance. The question is the extent to which the insurance is needed. In today's litigious environment, you should obtain several categories of necessary insurance for purposes of protecting your assets. You should consider reviewing and updating all insurances in conjunction with your yearly practice or business legal audit.

Do not overlook homeowner's insurance. Supplemental riders may be available for coverage lapses or insurance gaps, e.g., flood insurance, earthquake insurance, hurricane insurance, etc.

With regard to automobile insurance, make sure the liability portion of such policy is large enough. You may consider coverage of \$1,000,000.00 or more. In the event that you have prior accident claims or a poor driving record, this coverage may be more difficult to obtain than it may first appear.

Umbrella liability coverage may be important. You should consider adding broader liability coverage to your existing homeowner's or automobile insurance policies which may greatly expand the total amount of your liability coverage even though the increased premium may be small.

Regarding malpractice or liability insurance coverage, you should at least yearly review your policy(ies) to ensure that you are insured for necessary amounts. Additionally, you should review your policy(ies) for purposes of determining any exclusions or gaps which you may have in those policy(ies). The insurance which you presently have may not cover you in a given situation and you may be relying too heavily on such insurance. Therefore, learn to protect and insulate your assets as a back-up to the potential lack of insurance coverage.

If a claim is brought against you, the first step should be to promptly notify the insurer. Prompt notice is a condition to the insurer's obligation to indemnify under the policy and failure to give timely notice can be grounds for the insurer avoiding the policy's contractual obligations. An insurer has a duty to defend. Therefore, the insurer must provide competent legal counsel and must defend any claim which could conceivably come within policy coverage. Next, the insurer has a duty to indemnify. The insurer may defend a claim under a "reservation of rights" by which the insurer reserves the right to refuse to indemnify the insured professional because the insurer believes (but cannot prove) that it will not be obligated to pay under the policy. Insurers typically reserve the right to settle claims. It is in the best interest of the professional to settle a claim within the coverage limits of the insurance policy. Insurers sometimes refuse to settle if they feel the claim is worthless and you could then end up with a jury verdict which exceeds the policy limits. On the other hand, insurers sometimes settle frivolous claims for less than the "deductible" amount of the policy. In such situations, you would be personally liable for any amounts not covered by the policy. You should then establish a claim against the insurance company for

failing to settle the claim in good faith by demanding that the insurance company settle the case within policy limits.

In the event that you practice in an entity which is not a sole proprietor, e.g., a professional corporation, make sure that your practice entity is a "named insured" on the policy. If you are sued, your practice entity will also be sued and it needs a defense by the insurer.

Entity Selection. As a professional, you are always liable for your own acts. If your practice on your own as a sole proprietor, you are also liable if anyone you are supervising is negligent, and any judgment can be satisfied out of your personal assets.

Generally, a partnership is formed when two or more professionals or business owners agree to practice or own the business together and share the profits and losses on a predetermined basis. However, a partnership has generally been found to exist when professionals simply practice together and share expenses without a formal partnership agreement. This is significant because in a partnership, each professional is personally liable not only for his or her own actions, but also for those of any other partner or anyone for whom the partnership has supervisory responsibility.

A professional corporation or limited liability company provides partial protection to the professional practicing in a group or multiple doctor setting. Although an incorporated professional is personally liable for his or her own acts, a major advantage of a professional corporation or limited liability company is that an individual professional is not personally liable for the malpractice of other professionals practicing in the entity, unless he or she was involved in the negligent act.

Remember that just because you operate in the corporate form does not necessarily mean you have limited liability. You must do more than merely incorporate. You must operate, look and act, as a corporation. If you do not operate like a corporation, creditors of the corporation, e.g., malpractice judgment creditor, etc., can ask the court to ignore the corporation and impose personal liability on the shareholders. This is known as piercing the corporate veil. The state limited liability company statutes do not currently require the same formalities for continued limited liability as do state corporation statutes. However, limited liability company statutes may change in the future to be very similar to corporate statutes.

Further, there are various tax benefits that can be obtained from operating in the corporate form, e.g. retirement plans, health plans, disability plans, etc. If the IRS is successful in disregarding the corporation, this would result in a tax disaster. That is, the IRS could recoup all prior tax benefits and would further charge you interest and penalties.

If you do practice in the corporate form, you must maintain an up-to-date corporate record book. A corporate record book is generally one of the first items requested in an IRS audit or a lawsuit. All significant corporate transactions, e.g., payment of dividends, election of directors and officers, bonuses, etc., must be reflected by the appropriate corporate minutes. Additionally, you should never commingle personal assets with business assets. Personal funds should be segregated from business funds. All transactions between the corporation and its shareholders should be at "arms length" and should be documented as such. For example, loans

from the corporation to the shareholders should be evidenced by a promissory note which evidences a reasonable rate of interest and the terms of repayment.

Holding Title to Assets. Generally speaking, you should be cautious of joint tenancy ownership arrangements with both family and non-family members. 100% of the assets are exposed to the creditors of the other joint tenant. If a joint tenant is sued, pursued by the IRS or goes through a divorce, 100% of the assets held in this manner are exposed.

It is a viable option to place assets in a less vulnerable spouse's name. However, this strategy exposes the assets to claims of the spouse's creditors, e.g., automobile accidents, and would also subject the assets to probate upon the death of the spouse.

Another option is to place assets in a revocable trust for the benefit of the less vulnerable spouse. A revocable trust is a trust which can be revoked or modified. Sometimes it is referred to as a grantor trust. If a revocable trust is implemented correctly, the less vulnerable spouse is presumed to be the full owner of the trust assets. The other spouse has no ownership interest in the assets. There will be little likelihood that the other spouse's creditors can ever reach the assets contained in the trust. However, since the trust is revocable, the trust assets are still subject to the less vulnerable spouse's creditors. It should be noted that a grantor trust is not required to file a trust tax return.

To place the cash value and proceeds of a life insurance policy beyond the reach of a creditor, you can place the life insurance into an irrevocable life insurance trust. It should be noted that this type of trust is irrevocable. Therefore, it cannot be revoked or amended.

In creating an irrevocable life insurance trust, a professional might name the spouse, a trusted relative or advisor as sole trustee of the trust during the professional's lifetime. The professional can give the trustee money to pay the premiums on the insurance policy, in many cases, without incurring gift tax liability. The post-transfer growth and cash value of the policy are beyond the reach of creditors. In addition, upon the professional's death, the insurance proceeds would be paid to the trust and would be protected from creditors.

Where both spouses are vulnerable to potential lawsuits, or in the case of a single person, personal assets could be placed, e.g., home, stocks, bonds, etc., in a limited liability company, family limited partnership, or irrevocable children's trust, sometimes referred to as an IRC 2503(c) trust.

A family limited partnership is a partnership where there is at least one general partner and one or more limited partners. As the name implies, the limited partner's liability is limited to his or her investment in the partnership. The general partner is liable for all partnership debts. For example, the husband and wife would retain a 5% (or some small percentage) interest in the partnership as a general partner and the children would receive a 95% interest. It should be noted that the percentage of interest outlined above may vary on the basis of various non-tax and tax factors. The general partner(s) (e.g., husband and wife) control the assets in the family limited partnership. The limited partners have no say-so in the management of the assets or partnership affairs. At this point, the same results can be accomplished through the use of a limited liability

company as could previously be accomplished by use of a family limited partnership, but without general partners who do have liability.

Another asset protection planning technique involves the transferring of the professional corporation stock to a trust. Under certain circumstances such transfer can provide significant asset protection. For example, a professional is the sole shareholder of a professional corporation. The professional is also involved in various non-professional ventures. A creditor from one of these other ventures could attempt to attach the stock in the professional corporation and garnish the shareholders' wages (which represent the profits from the practice). In this case, the professional could convey the stock to a trust. In some states, it has been held that a trust can hold the stock of a professional corporation so long as the trustee is a licensed professional. Thus, a creditor may be prevented from reaching the corporate stock.

Protection of Retirement Plan Assets from Creditors. There exists a general misconception that a participant's interest in a retirement plan is protected from creditors in all cases. This is untrue. Whether a participant's interest in a retirement plan is subject to the claims of creditors depends upon the type of plan, the participant's control over the plan and depends on whether a claim against the plan is filed in a state or federal court.

First, a participant's interest in an IRA may be subject to the claims of creditors, depending upon state law. In such case, there would be no creditor protection in this type of retirement plan. As a general proposition, tax-qualified retirement plan assets are protected from creditors except for tax liens, child support orders and misappropriation of retirement plan assets.

The foregoing provides you with an outline of issues which relate to asset protection planning. However, the most critical matter relating to the implementation of any viable asset protection plan is to do so with proof, if needed at some future date, of valid business purposes at a time when there are no pending or threatened lawsuits. Additionally, the implementation of an asset protection plan should be coordinated with your estate plan.