Covering Your Assets

Ever been sued by a creditor? Had your personal savings account and/or assets confiscated? Don’t laugh . . . it could happen to you!

By Jay Mitton, Esq.

Daily the U.S. media shatters our peaceful world with:

“We are in a lawsuit crisis!”

“One out of six adults will be sued this year!”

“Doctor quits practice but is sued and looses all his assets and his retirement plan!”

As a practicing attorney, I receive ten times more speaking requests on asset protection today than I did even two years ago. A crisis is indeed here, but the solution is also here! The solution is tragically overlooked and hence many contractors lose their assets by paying the ultimate exorbitant price for ignoring the legal steps a contractor must consider taking to insulate his or her personal assets and corporate assets.

Many contractors are tangentially aware of possible solutions and try their best to “insulate” and “protect their assets” without realizing that “asset protection” is perhaps the most complex and highly-specialized area of law practice today. If you think anti-trust law or tax law is complex, then you ought to consider “asset protection” law. Look at some of the myths, half-truths and partially effective steps many well-
intended contractors often take in an effort to protect themselves and their assets, but often find their efforts futile and ineffective.

Many think joint tenancy, tenancy by the entities or community property forms of ownership will protect. (Many have lost it all by such reliance.)

Some contractors place all their assets in the non-contractor’s spouse’s name thinking that if they get sued they can say, “I don’t own anything!” (Thousands lose their wealth each year by such reliance. Courts often hold such conveyances in violation of the “Fraudulent Conveyances Act” and some courts extend the statute of limitation period by creating “Constructive Trusts” with a non-contractor’s spouse in essence presumed to be holding title to the assets as a “Quasi-trustee” for the benefit of the contractor’s spouse and hence possible total loss of the family wealth.) Some contractors place all or a portion of their assets into their children’s names or in names of other family members. (The Fraudulent Conveyances Act often nails contractors here too!)

Some contractors set up irrevocable trusts in an attempt to insulate their assets. (Recent judicial trends are now allowing creditors to seize “your” interest in the trust if you have an “income” interest or an interest in “principal”.

Many contractors erroneously think that if they use a corporation they will be protected! (You should see how quickly the courts allow the plaintiff to penetrate the supposed liability shield that you thought you had with your corporation!)

The secret to asset protection lies in how you organize personally and professionally.

That’s enough of the problems! Now let’s look at the solutions! The ultimate asset protection strategy for many contractors lies in how they hold title to their assets. I do not discount the need for insurance and the care and professional attentiveness you give to your clients. But what happens if your insurance company does not protect you or if you are sued for $3 million but only have $250,000 in liability coverage? Or what if your insurance company becomes insolvent or even bankrupt? Or what happens if you are sued for $2 million? NOW WHAT HAPPENS TO YOU AND YOUR ASSETS? The answer is clear. The courts will frequently allow your judgement creditor to seize your assets and in many cases attach a portion of your future income.

The secret to asset protection lies in how you organize personally and professionally. Very simply, there are two
areas you must look at in detail: 1) your professional practice and how it should be structured, and 2) how to hold title to your personal and family assets.

Now let’s look at each of the tools in the big picture and review in summary form how each helps in Asset Protection:

1. PROFESSIONAL LEVEL ASSET PROTECTION PLANNING

The Professional Corporation

Frequently the corporation is our initial shock absorber from a lawsuit. Whenever a contractor has one or more employees, I generally recommend that he be incorporated. Admittedly, a corporation is not perfect as a suit protector—but still it is generally much better than the general partnership or proprietorship form of operation. If two or more contractors practice together, I almost always insist on the corporate form of operation. Frequently, I will have each contractor incorporate separately and then the contractors practice together as a partnership of professional corporations. Be cautious about putting real estate, stocks, bonds and investment assets into the corporation. If the corporation gets sued, it is far better to have few corporate assets seizable by the judgement creditor. (See the Section below “Personal level asset protection” to see the alternative entitles used to hold assets rather than holding such assets in the corporate name.)

The Children’s Trust

The Children’s Trust (I.R.C. Section 2503 “C”) ties in beautifully as an income tax saving device if the beneficiaries are age 14 or older. The most frequent application is for the children’s trust to own some or all of the businessman’s equipment and then lease the equipment to the professional corporation or the “partnership” or professional corporations. In addition to Income Tax savings, the assets on the children’s trust are usually protected from lawsuits against the dentist, his spouse and his corporation. (One word of Caution: The need to use an “independent” trustee for a children’s trust must be considered.)

The “S” Corporation

An “S” corporation is frequently used in tandem with a “C” corporation so that some of the professional income can be spread to the “S” corporation and hence taxed in the “lower” income tax brackets of the children or other “S” corporation shareholders. A contractor, for example, might have a related business operated by a separate “S” corporation where the children are the shareholders (owners). The assets held in this kind of “S” Corporation are
generally not available to the judgement creditors of the contractor and his
spouse because the stock is owned by the children.

II. PERSONAL LEVEL

ASSET PROTECTION

PLANNING

No Irrevocable Trusts

Two irrevocable trusts are set up to
hold the life insurance respectively on
the husband and wife so that at the death
of the surviving spouse, the insurance
will not be subject to federal estate
taxes. Also, since the trust is irrevo-
cable, excellent asset protection is avail-
able for the assets held in this kind of
trust. Such trusts can own more than just
life insurance! Attention must be paid
to who the trustee is, if you want added
suit protection benefits from such a
trust. It is generally advisable for some-
one other than the husband or wife to
be the trustee. Also, the typical spend-

The Funded Living Trust

The Funded Living Trust is used for
the twin estate planning purpose of
avoiding probate on the assets held by
the trust and also securing estate tax
savings via the marital deduction and
contractor's trust provisions. Many other
estate planning benefits are also
available. Some limited suit protection
benefits also exist with this kind of trust
where one spouse is clearly more
vulnerable to litigation than the other.
In such situations, assets are generally
placed in the less vulnerable spouse's
trust holding fewer assets. However,
that it was a fraudulent conveyance and
an attempt by the more vulnerable
spouse's trust to keep those assets
beyond the reach of the more vulnerable
spouse's creditors. Courts can attack a
transfer to a less vulnerable spouse's
trust on the grounds of a fraudulent
conveyance. Therefore, the trust must
be properly structured to avoid this
problem.
reaches of his/her creditors. Generally, however, the longer the assets are held in the less vulnerable spouse’s trust, the greater the suit protection from attack by a creditor of the more vulnerable spouse.

**Four Limited Partnerships**

Four limited partnerships were included in our “Big Picture” to complete the complex interrelationships of estate planning, income tax planning, and lawsuit protection of assets held in limited partnerships. The limited partnership has the following generally acknowledged asset protection advantages for a contractor and his family who have transferred assets to a family limited partnership.

1. Your personal judgement creditor merely gets a charging order against your limited partnership interest.
2. Your personal judgement creditor cannot seize any assets of the limited partnership (unless, of course, he is a creditor of the partnership itself).
3. The creditor cannot remove you as general partner of the limited partnerships; you continue to control all of the partnership assets and take salaries, wages, loans and other benefits.
4. The creditor has no vote nor management in the affairs of the limited partnership. (He is treated like an assignee, not a substituted limited partner).
5. The creditor cannot demand income from the limited partnership, but receives income only as distributed —if distributed! (Consider a clause in the limited partnership agreement which allows the general partner to retain all of the income for the future needs of the partnership.)
6. The creditor may now be in the unenviable position of having to pay income taxes on the income “earned” by the partnership even though it is not distributed to him! What a shocking blow to a judgement creditor! (C.P.A.’s call this a “K.O. by a K-1.” See Rev. Rul 77-137.)
7. Remember, however, that if the source of the lawsuit stems from an action or activity of the limited partnership itself, then all assets inside
of that particular limited partnership are vulnerable. For example, suppose your limited partnership decides to go into the business of construction of motorcycles—then you have now placed at risk all of the assets inside of that particular limited partnership. Therefore, you must now consider having two or more limited partnerships (i.e., one for the motorcycle manufacturing business and one or more additional limited partnerships to hold your cash, stocks, bonds, real estate and other assets.)

The reasons at least four limited partnerships are used by many of my own clients and in the “Big Picture” example is because limited partnerships “B”, “C” and “D” each shield a separate property, so that if a suit occurs because of a tenant’s death in the ten-unit apartment owned by limited partnership “B”, the suit does not domino against the assets in limited partnership “A”, limited partnership “C” nor limited partnership “D”! You thereby spread the risks by using multiple limited partnerships.

Also, since there are not as many income tax advantages to owning land in limited partnership “D”, we can give the children a greater percentage of ownership (i.e., 80 percent), whereas in limited partnerships “B” and “C”, mother and father may need a greater percentage ownership from an income tax standpoint. Also, note the minimal interest assigned to the husband in each limited partnership. This is often because of the husband’s suit vulnerability due to his own business or professional activities.

Now, what if both husband and wife are vulnerable to suits because of their respective business or professions? In such cases, I would consider having the husband and wife own equal interests in the respective limited partnerships and perhaps increase the limited partnership interests owned by the children, grandchildren and others. For example, in a recent case where both husband and wife are doctors, I set up five limited partnerships. But I had the husband and wife each own 20 percent interest in the five partnerships and had the remaining 60 percent limited partnership interests owned by their children and grandchildren.

Asset protection for a contractor lies in how well a contractor protects his corporate assets and his personal assets. As this paper has set forth, now is the time for one to urgently consider:

1. Protecting your corporate assets by having few assets in the corporation name and complying with all the corporate formalities imposed by law and remembering at the same time the potential dangers of having your spouse listed as an officer of your own corporation.

2. Protecting your personal assets by using the combination of multiple limited partnerships and living trusts to assure maximum protection of your personal home, bank accounts and investments.