Berkeley Investment Advisors

Real Estate Brokerage/Retirement Planning

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Primer on Legal Structures for Asset Protection

In our society, once you have sufficient assets, people will try to take them away from you; lawsuits and taxes are a threat to your wealth. While my business is helping you make money, I want you to know how to defend your assets so we'll have something to invest. This month's newsletter will show you what you need to do to protect your assets.

Terminology

There are a lot of choices for how you hold title to assets and the first step is to understand what legal entities are available. The attributes that are most important to understanding the usefulness of each entity are:

1. Its ability to prevent internal lawsuits from reaching the owner
2. Its ability to protect assets from external claims against its owner[1]
3. How the entity affects your tax liabilities

Internal lawsuits are those connected with assets or business activities owned by the entity. External claims are indirect claims on the entity's assets because they are claims against the entity's owner. For example, a lawsuit for an accident at a rental property owned by entity B would be internal to entity B. The lawsuit would be external to any person or other entity that does not have direct ownership of the property. Thus the lawsuit would be external to any entity owned by B.[2]

Except for (subchapter) C corporations and certain irrevocable trusts, all of the entities we'll discuss are not separately taxable for federal income tax purposes[3]; taxable income or loss is passed through the entity to the owner's tax return without any tax at the entity level. Although C corporations incur double taxation, they also provide the owner the ability to

[1] By external I mean that the claims are not related to the entity but are claims against the entity's owner.

[2] A lawsuit against B would also be external to the owner of B or any entity owned by the owner of B.

[3] Note; however, that there may be some form of taxation at the state level. For example, California imposes a Franchise tax on (subchapter) S corporations.

deduct certain costs which otherwise would not be deductible. For example, Internal Revenue Code (IRC) section 79 allows a C corporation to deduct the cost of employee insurance. Double taxation can be avoided for a business incorporated as a C corporation by paying compensation to the owner to zero out any profit. Although payroll taxes must be paid on this compensation, these taxes are lower than corporate tax rates.

The following table summarizes the key attributes of the entities we will use:

Entity	Taxation	Lawsuit Containment	Asset Protection
C Corporation	Double taxation, employee benefit deductions	Only partial – officers reachable	None – shares can be taken.
S Corporation	Pass through	Only partial – officers reachable	None – shares can be taken.
Limited Liability Company (LLC)	Pass through	Yes – members can't be reached	Not for single member. Yes if ownership divided.
Limited Partnership (LP)	Pass through	No – general partner is liable	Yes – assets are not reachable
Irrevocable Trust	Taxable on undistributed earnings	Yes	Depends on jurisdiction and drafting of the trust

In this article we will not cover general partnerships because these result in unlimited liability to their owners and are not useful for protecting assets. Revocable trusts will not be covered here because they have no effect until they become irrevocable (when a trustor dies). As we will see, each of the entities above is useful for different purposes.

While LLC's offer advantages versus corporations, many licensed professionals are prohibited from doing business using LLC's. For example, doctors cannot run their practice as an LLC.

Sources of Lawsuit Risk

In devising a strategy we must distinguish between safe and dangerous assets and separate the two legally. For most people the biggest sources of risk are:

- Operating a business
- Rental real estate
- Vehicles

On the other hand, passively held stocks, bonds, and cash are unlikely to allow a cause for a lawsuit. These assets are thus considered safe assets.

Isolating Lawsuit Risk

Generally we use LLC's to hold our dangerous assets. A corporation would be used for an operating business not allowed in an LLC. In addition, we use multiple LLC's to separate risks from other assets. Thus, we set up an LLC to hold vehicles and a separate LLC for each rental property. If a lawsuit is filed against any single entity, the others are unaffected.

If you operate a business not eligible for an LLC, set up either a C corporation or an S corporation for the business. Minimize the assets held by the corporation by owning them outside the corporation and leasing them back to the corporation. This limits the assets available to the corporation, thus reducing its attractiveness as a litigation target. Although in theory, corporations offer limited liability, in practice, officers and directors will be named in any lawsuit. Even though you may prevail in fending off liability as an officer/director, you will still have to defend yourself and probably spend a lot of money to do so. In order to reduce the likelihood of such a lawsuit, eliminate the temptation by reducing the assets available to satisfy any judgment against you.

Lawsuit Mechanics and Asset Protection

Lawyers and their plaintiffs are motivated by getting paid if they win. When you reduce the chances of collecting, you reduce the chances of being sued in the first place. Thus, our strategy is to minimize assets reachable in the event a judgment is entered against us or one of our entities. This is where the Family Limited Partnership (FLP) comes in handy.

When a judgment is entered against you in a lawsuit, the court issues a writ of execution to the prevailing party. This authorizes the marshal to seize your property to satisfy the judgment. If you own property via an interest in a partnership, an LLC, or a corporation, the judgment creditor cannot seize assets directly. In the case of shares of a corporation, the creditor would seize the shares and if the shares represented control (50% +1), they could sell the assets to satisfy the claim. If the property is held via a partnership or LLC, the creditor would apply to the court for a charging order. A charging order does not allow the creditor any control over the entity; it merely entitles the creditor to receive any distributions to your ownership interest. The partnership or LLC documents should state that no distributions will be made to any partner or member interest that is subject to a charging order. Thus the partnership or LLC would continue to reinvest funds and limit distributions to those members not subject to the charging order. In effect the charging order is worthless and this circumstance will likely discourage the filing of any lawsuit.

In some states the creditor could foreclose on your interest in the partnership or LLC. This is potentially very costly since the creditor could end up with assets worth more than the judgment amount. In order to prevent this, the Family Limited Partnership interests should not be held directly. Instead, an offshore LLC could be used to hold the interests. In turn, ownership of the LLC would be vested in an Irrevocable Trust[4]. You would be both the beneficiary and a co-trustee of the Trust. Note that this chain of ownership has no impact on tax liabilities or filing.

Personal Residence Protection

Your personal residence should not be put into an LLC or the FLP because the deductibility of mortgage interest could be denied. Instead, put it into a trust with yourself as the Trustee and the FLP as the beneficiary. The interest deductions still flow directly through to your tax return and you have complete control over selling or refinancing the property. The trust serves to place your residence inside the FLP for purposes of asset protection and thus it will not be available to satisfy any judgment against you.

Tax Benefits

Although my primary focus here is on protection from lawsuits, it's worth mentioning some of the tax benefits available using the structures described above. The FLP can be used to shift taxable investment income to those members of the family with the lowest tax rates. Note that there is no need to actually distribute the income to the limited partners. You can simply distribute enough cash to pay the taxes owed by the limited partners. Giving partnership interests to family members also avoids probate and can be used to reduce estate taxes. For purposes of the estate tax exemption and annual gift limits, the value of the limited partnership interest will be discounted from the value of its share of partnership assets because of the lack of control and liquidity for the interest. Appreciation of underlying assets subsequent to the gifts will not be counted against the exemptions.

Holding single rental properties in LLC's has the additional benefit of allowing a buyer to avoid reassessment for property tax purposes when buying the property. They can buy the LLC instead of the property itself. If it's a single member LLC this will qualify for tax deferred exchange treatment. This can greatly improve net operating income in the hands of the new buyer and therefore increases the value of the property at sale.

[4] Delaware, Alaska, and Nevada have laws allowing asset protection trusts in which the grantor is also the beneficiary and has substantial control over distribution of assets.

Conclusion

Appendix A diagrams the relationships of an asset protection strategy designed using all the techniques described above. There are, of course, costs associated with this structure and depending on your current holdings, some parts of the scheme may not be worth the costs – yet. All of the strategies must be executed properly with all formalities taken care of for the entities to hold up under court challenge. A lawyer will generally be needed to advise on specifics. We urge all our clients with substantial assets to take action as soon as possible to reduce their vulnerability to lawsuits.

Featured Investment Opportunity

Blue Heron apartments is twelve 2-bedroom units in Riviera Beach, Florida. The property, priced at $795,000, would require a total investment of $250,000 assuming a loan of $562,000 and $15,000 of closing costs are paid by the seller. I estimate cash flow of about $4,000 in the first year and an overall first year after-tax return of 14%. This area has good demographics and the property is 100% occupied.

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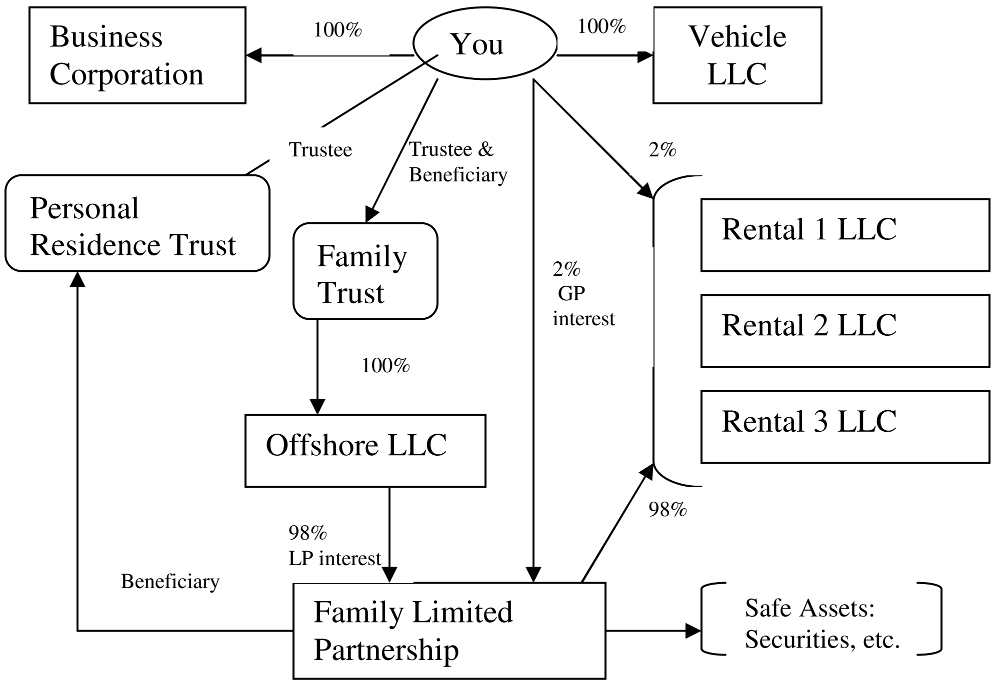
Exhibit A


Business Corporation
100%
You
100%
Vehicle LLC
Trustee
Trustee & Beneficiary
2%
Personal Residence Trust
Family Trust
2% GP interest
Rental 1 LLC
Rental 2 LLC
Rental 3 LLC
100%
Offshore LLC
98% LP interest
98%
Beneficiary
Family Limited Partnership
Safe Assets: Securities, etc.