

ANATOMY OF ASSET PROTECTION

Managing your legal risks

PREPARED BY

LAW OFFICES OF THOMAS J. BOUMAN, PLLC

ESTATE PLANNING • INHERITANCE PROTECTION

7650 E. BROADWAY BLVD. #108

TUCSON, ARIZONA 85710

www.tomboumanlaw.com

Copyright © 2007 Law Offices of Thomas J. Bouman, PLLC

By: Thomas J. Bouman, Attorney at Law

Mr. Bouman's practice areas include estate planning and inheritance protection, with emphasis on comprehensive estate planning for persons with more than 20% of their net assets in tax-advantaged investment accounts. His law firm is widely respected for its use of office support technology and advanced estate planning techniques. Mr. Bouman can be reached at (520) 546-3558 or tom@tomboumanlaw.com.

Article One

What is Asset Protection Planning?

Section 1.01 Definition

Asset protection planning is simply the use of lawful methods to manage legal risk, by arranging financial affairs so as to discourage frivolous lawsuits, and minimize exposure to claims of future creditors.

Most asset protection techniques are not complex, risky, or illegal. A qualified attorney can help the physician structure his or her assets in a manner that takes advantage of several effective strategies. Contrary to the schemes of many asset protection promoters, the best plan is understandable, tailored to the client, and tested.

Section 1.02 Physicians Need Asset Protection

Anyone can be sued for any reason in the United States. Whether a claim against you has merit or not, the simple fact of being named in a lawsuit will cost you time, money and energy. While a groundless claim can be thrown out of court, it still comes with a fight.

Recent studies show that Americans file more than 17 million lawsuits per year, and about 450,000 represent personal injury claims. Higher insurance premiums are partly a result of higher claim amounts against physicians. The average payment for a malpractice claim has risen to approximately \$350,000, twice the rate of inflation. The average judgment from a jury verdict is \$1.3 million. About 14 malpractice cases are filed annually for every 100 physicians, and about 30 percent of those claims result in an insurance payment.

Reasonable minds can differ on the reasons for the increase in lawsuits charging malpractice, but there is no doubt that rising claims and premiums reflect that many people are willing to litigate almost anything. A physician is particularly susceptible because of his or her above-average income and assets, or at least the perception of them, and because medicine, or lack of good medical service, is an emotional lightning rod in our society. Therefore, even the most careful physician is not immune to a frivolous lawsuit. It only takes one disappointed patient, and his or her attorney, to permanently soil a physician's reputation, trigger a sizable increase in malpractice premiums, or possibly wipe out a lifetime of savings.

Article Two

Ethical and Practical Issues

Section 2.01 Effective Planning

Asset protection planning is full of legal and ethical traps, especially because many techniques involve transfers of assets. Plaintiff personal injury attorneys use the influence of power to attack the validity of new strategies as soon as possible. Asset protection planning is often a cat-and-mouse game, featuring the leading minds of asset protection theory, against the personal injury attorneys seeking contingency fees. The fraudulent transfer laws make planning almost impossible after a lawsuit has been filed, which makes it important to act now.

The most effective planning relies on openness and honesty, despite that a secondary market of asset protection hucksters thrives in this country. Many of these charlatans place heavy pressure on physicians to buy expensive, but often worthless, asset protection kits and structures. Rather, good planning does not use secrecy as a prerequisite to effectiveness. As this is a specialized legal area, we strongly recommend retaining an attorney well versed in debtor/creditor laws, trust law, civil procedures, estate planning, and bankruptcy law. This also has the benefit of attorney-client privilege.

Section 2.02 Methods to Avoid

Watch out for Nevada Corporation and limited liability company scams that proclaim the asset protection benefits of incorporation in Nevada. They are not worth the cost, and have a bad reputation among respectable planners.

There is nothing magical about a Nevada corporation, because its assets are not protected from seizure, attachment, or garnishment by an Arizona court. Nevada courts have to recognize judgments obtained in other states under the Full Faith and Credit clause of the U.S. Constitution. In addition, try telling a federal judge that you refuse to provide information because of Nevada's secrecy laws. You may soon find yourself on the wrong side of the jail bars.

One true advantage of the Nevada corporation is state income tax savings, because Nevada has no income tax. However, the IRS and state revenue departments are aware of many who attempt to evade taxes in Nevada, and that might explain the increased chance of audit when a Nevada corporation is used. The only people who really benefit from the Nevada laws are Nevada residents who are lawsuit defendants in Nevada.

Article Three

Strategies to Reduce Your Lawsuit Potential

Section 3.01 Ownership of the Medical Practice

No medical practice should be held as a sole proprietorship, but rather as an entity such as a corporation, limited liability company, or limited partnership.

For many, the professional corporation is the best choice. In addition to liability protection for its owners, the PC permits the most tax savings opportunities. Tax-deductible fringe benefits include health insurance premiums, out-of-pocket medical expense reimbursement, group life insurance, disability insurance, wage continuation, and many types of qualified and non-qualified retirement plans.

The PC structure prevents non-physicians from acquiring ownership of the company, and isolates any malpractice claims against a shareholder physician from creating personal liability on the part of other physicians in the practice. The PC limits a shareholder's liability for corporate actions to the assets of the corporation: the shareholder will not be personally liable. Because the PC does not shield a physician from professional malpractice claims, the main asset protection purpose is to limit personal liability against other kinds of lawsuits, including slip and fall and employment related cases.

Most medical practices have medical equipment of substantial value. Since these assets can form the lion's share of a medical practice's assets, having the corporation or the physician individually own the equipment would expose any equity in the assets to creditors. One strategy to avoid this is to establish a separate LLC to hold the equipment. The LLC then leases the equipment back to the corporation. The lease payments work to remove funds from the potential reach of the practice's creditors. A similar strategy works with land and buildings used by the practice.

Section 3.02 Exemption Planning

Exemption planning may provide some opportunity to protect assets even after creditor problems have arisen. Arizona has adopted rules that exempt certain assets from creditor claims. Provided that such assets were not converted from non-exempt property with intent to hinder, delay or defraud creditors, the exempt assets will be protected to the extent the law provides. The law is very specific in this regard; for example, exempt property includes three living room lamps, one radio alarm clock, one vacuum cleaner, all engagement and wedding rings up to \$1,000 value, one family Bible, one car up to \$5,000 value and one firearm. In addition to personal items, the Arizona homestead exemption protects up to \$150,000 of equity in your primary home from any creditor claims. Further, Arizona law provides that all of the cash value in any permanent life insurance policy, such as whole life, or variable life, and any annuity policy, are protected.

There are some exceptions to the general rules outlined above, such as mortgage liens and contractor liens. Although courts have sometimes ruled that such transfers are fraudulent, one can convert non-exempt assets into exempt assets by purchasing exempt assets with cash, or marketable securities. Courts have consistently held that borrowing money to buy exempt assets with no intent of repaying, is fraudulent. There is no definitive test as to whether conversion to an exempt asset is fraudulent; courts focus on the intent of the transaction. However, federal bankruptcy law can deny an exemption only if property is converted from non-exempt assets less than one year before a bankruptcy filing, and if evidence of fraud is shown.

Under both federal and Arizona laws, qualified retirement plans and IRAs are exempt from creditor claims. This is especially important for successful physicians, because they will often contribute company profits to a retirement plan because of the income tax deferral. Since the exemption is unlimited, it is possible to protect large sums of money in these accounts. As long as the plan is established and maintained properly, the bankruptcy laws treat all plan funds as protected from all creditors except the IRS. An exception exists for funds contributed within 120 days of a bankruptcy filing.

Arizona law provides that one spouse will not be personally liable for the debts of the other. However, as Arizona is a community property state, a creditor of either spouse will be able to attach community property assets upon obtaining a judgment. The other spouse's separate property will be protected unless they have commingled the separate property and turned it into community property. Thus, it may be beneficial for a physician intending to marry a non-physician to keep assets separate, so as to avoid subjecting both spouses' assets to malpractice claims against the physician's spouse.

Section 3.03 Domestic Trusts

Trusts are established for various asset protection, estate planning, and financial management purposes. The most common trust is the revocable living trust, which is mainly used for probate avoidance and assuring appropriate management of assets in case of disability. This trust does not provide effective asset protection because the trustor (or trustmaker) can freely revoke the trust for his or her own benefit. There is no restriction placed on the trustor's use of the trust assets, and a creditor can claim most assets held by a revocable living trust. There may be some asset protection benefit, however, because trust assets are no longer held in the trustor's own name, and might be harder to locate when a potential creditor does an asset search.

Trusts established for other family members often include a spendthrift provision, which generally limits the ability of the beneficiary's creditors to reach the trust assets. A spendthrift provision, under state law, prohibits the assignment of the beneficiary's interest or the payment of distributions to other persons or entities besides the beneficiary. Estate planning attorneys regularly include spendthrift protection in trusts for surviving spouses and children.

For those with estate tax concerns, and others concerned about creditor protection, a credit shelter trust is funded at a spouse's death for the benefit of the surviving spouse.

The credit shelter trust assets are protected from the surviving spouse's creditors. For example, upon the death of a physician's spouse, an amount can be set aside in an irrevocable trust for the benefit of the physician. All income would be payable to the physician, and principal would be available for health care, support and maintenance. The trust principal would also be safe in the event a judgment is obtained against the physician.

Trusts for children also provide substantial asset protection. The interest of a child in a trust with spendthrift protection is not available to the child's creditors or to an ex-spouse upon divorce. For added protection, an institutional trustee such as a bank or trust company can act as trustee to prevent the child from emptying a trust fund for questionable needs or wants.

Discretionary trusts for the benefit of several beneficiaries can provide considerable protection from creditor claims even without a spendthrift clause. If a trustee is given discretion to make payments of income and principal among several children, a creditor or spouse of any one child cannot reach trust assets to satisfy a judgment. The reason is that no beneficiary has a vested right to any of the trust assets.

It is also possible to set up a trust to protect one's own assets immediately, in what's called a "self-settled asset protection trust." This kind of planning requires careful analysis, because a self-settled trust is irrevocable. The trustor must give up at least substantial control of the trust assets in order to obtain the protection. Although some optimistically claim that self-settled asset protection trusts are bulletproof, there are strong public policy arguments against the use of these kinds of trusts. Whether these arguments have merit in a court of law is unknown, because self-settled trusts established under domestic laws have not yet been tested in the courts.

Section 3.04 Foreign Trusts

In the 1980s and 1990s, foreign asset protection trusts became commonplace among some of the wealthy. Many foreign countries enacted laws that make it difficult for creditors to reach the assets of a trust created under their laws. After its popularity grew initially, the foreign asset protection trust then obtained a negative reputation, mainly due to fraudulent people.

Others attempted to use foreign trusts to evade U.S. income taxes. To be certain, the foreign asset protection trust is not a tax savings vehicle. Trust income from around the world is taxed to the U.S. trustor. Although referred to as an irrevocable trust, the assets are included in the estate of the trustor for estate tax purposes. Nevertheless, the foreign asset protection trust continues today as a viable creditor protection tool.

The first potential advantage of a foreign asset protection trust is that many foreign countries will not honor a judgment won in the U.S. For all practical purposes, this means that a judgment creditor will have to re-file the case in the courts of the foreign country, learn all about the laws of that jurisdiction, and go through the entire costly, time-consuming process of winning a verdict against the debtor a second time.

The second potential advantage of a foreign situs trust is that the substantive laws of some jurisdictions are much more favorable to debtors. Examples of such debtor friendly laws include severe time limits on when a lawsuit may be filed, ability to transfer assets to a trust for your own benefit, and the ability to retain far more control over the assets in the trust while still retaining protection against creditors.

A third and more subtle advantage is psychological. A potential plaintiff researching the viability of a lawsuit will almost certainly spend some time looking into the physician's ability to pay any judgment that may result. When this person discovers that assets are harbored in a foreign trust created in an unfamiliar jurisdiction, the physician will be in the position of strength. Suddenly, the potential plaintiff has more to lose in terms of time and money spent litigating the claim, while the physician has far less to lose. On this "uneven playing field," court papers may never be filed in the first place.

Section 3.05 Family Limited Partnerships

Family limited partnerships can provide substantial creditor protection. Another advantage is the substantial valuation discounts these entities provide to minimize estate and gift taxes. The law is constantly changing, however, and planning requires high technical competence by attorneys in this area.

A family limited partnership ("FLP") is organized under state law. Typically, a physician would place his or her investment assets in the partnership. In order to ensure partnership status, the physician would receive a 1% interest as general partner, and a revocable trust for his or her benefit would receive a 99% interest as the limited partner. The general partner always has sole control over the partnership.

When investment assets are placed in the FLP, a creditor is severely restricted from reaching them once a judgment has been obtained. A creditor may force the partner to transfer his or her interest to the creditor, but the creditor only receives a non-controlling interest, and is taxed on that share of partnership income, even if no distributions are made. A creditor would more likely seek a charging order against the creditor's share of any future distributions. However, as general partner, the physician would not be obligated to make distributions.

The charging order does not actually protect the assets from the creditor claim, but certainly places the creditor in a difficult situation. Some case law exists holding that a partnership interest can be sold to satisfy the claims of a creditor when the charging order doesn't work, but these holdings rely on precarious legal reasoning. One should also be concerned with protection of the general partnership interest. It may be appropriate to consider creating a separate entity, such as another partnership, limited liability company or corporation, to serve as the general partner.

Section 3.06 Limited Liability Companies

The limited liability company ("LLC") has quickly become the entity of choice for investors in residential and commercial real estate. It can be taxed like a partnership for

income tax purposes, which prevents the double taxation inherent with C corporations. In addition, the LLC provides limited liability for its owners, referred to as members.

Each state has its own LLC statutes. Arizona's are favorable because registration is simple and there is no annual fee. For tax purposes, each LLC must file an informational return, but the income and losses flow through to the member's personal tax return. Thus, the LLC works well for real estate holdings because the investment is segregated from the investor's other assets for liability purposes and tax reporting is simple.

The LLC does not immunize its owner from lawsuits. For instance, if a member commits an intentional tort, such as assault and battery, against a tenant of rental property owned by the LLC, the member would be personally liable. Environmental contamination claims may also qualify for an exception. Additionally, a member who signs a personal guarantee on a loan to the LLC would be personally liable for that note. However, a member is not personally liable for debts in the name of the LLC alone, or for negligence that is a result of a management decision.

For asset protection, each LLC should have more than one member. In one recent case, a federal bankruptcy judge denied charging order protection and allowed the bankruptcy trustee to take possession of a single member LLC's assets to benefit creditors. Many analysts believe that the judge's reasoning is correct and that single member LLCs offer no additional protection than would a sole shareholder corporation. No Arizona case law exists on this issue, but the wise choice is to have another member buy into the LLC at or near its inception.

Section 3.07 Gifting

Gifting is an interesting option in some instances. The only bullet proof asset protection technique is not to own the asset at all because what you don't own can't be taken from you. However, if it is not handled properly, a court may ignore a gift and seize the asset anyway. It is best to select assets for gifting that the transferor will not continue to use. For example, gifting an art collection to a child without removing the collection from the transferor's house may be considered a fraudulent transfer. It is also important to show a pattern of giving, as opposed to a one-time gift that could be interpreted as a fire sale to avoid a creditor.

If you are willing to give up control, making gifts is an excellent way to protect family assets. Usually it is combined with estate planning objectives, such as minimizing estate taxes. Consideration of the gift tax consequences is also necessary.

Section 3.08 Premium Financing

Premium financing has been around a long time as a means to purchase very large amounts of life insurance. However, it can be used for asset protection purposes by encumbering security holdings, real estate and other assets. These assets are used as collateral to obtain the financing of the policy. The result is that creditors would have to

wait for payment until the policy proceeds are paid. This might permit better positioning when negotiating a settlement with a potential creditor.

Section 3.09 Umbrella Insurance Policies

All physicians should have an umbrella insurance policy, which provides additional benefits if other policies' limits are exceeded. The policy might become a target for a plaintiff's attorney as opposed to the physician's personal assets.

Article Four Conclusion

Section 4.01 Layers of Asset Protection

Many asset protection strategies must balance various interests, and may require layers of protection. Each situation is unique and requires careful study. Short of gifting or selling an asset, the most effective strategies require giving up some degree of legal control of the property. For example: Jack and Jill own real estate in the US with a fair market value of \$2 million. A homestead exemption does not apply. If Jack and Jill own the property outright, there is no asset protection. They can add some level of protection by contributing the property to a domestic limited liability entity such as a FLP or LLC, and retaining full management authority. Although this may be sufficient, they might choose to add another layer of protection by using the FLP or LLC, and then obtaining a mortgage with a US bank for a significant portion of the property's value secured by a deed of trust. The proceeds would be contributed to a separate FLP or LLC.

Another layer of protection might include transferring a majority of the FLP or LLC interests to a foreign asset protection trust. This layer could be strengthened by having Jack and Jill give management authority to a foreign trustee, or by retaining only a small minority interest in the FLP or LLC. The highest degree of asset protection would probably involve getting a mortgage with a foreign bank and contributing the proceeds of the loan to a separate foreign trust.

Section 4.02 The Bottom Line

Although it is not likely that the average physician will be successfully sued beyond malpractice insurance limits, the benefits of a complete asset protection plan are clear. First, the physician will be in a better position during settlement negotiations. Second, it may be possible to lower malpractice insurance premiums by reducing the number of lawsuits filed. Third, the physician can practice with more confidence knowing that his or her personal assets are adequately protected from frivolous lawsuits.

Certainly physicians should seek to avoid bad investments and divorces because they are even more likely to cause “asset decay” than a lawsuit. Asset protection planning obviously cannot prevent these events, but it can help a physician avoid the financial disaster that can result from a high profile malpractice case.

By taking proper precautions before a potential plaintiff puts your name on the papers starting a suit, you can avoid not only the threat of losing your assets to a creditor, but also the threat of being sued in the first place.