Solidifying Your Client's Asset Protection Strategy: Multiple Entities in Multiple Jurisdictions

by Richard Kahler, CFP®, CCIM, and Richard Colman, J.D.

Richard Kahler, CFP®, CCIM, offers integrated financial planning through Kahler Financial Group in Rapid City, South Dakota. He is a nationally known speaker, educator, and co-author of two books, Conscious Finance and The Financial Wisdom of Ebenezer Scrooge.

Richard K. Colman, J.D., is a registered financial adviser and noted public speaker and tax expert who offers a combination of legal, tax, and business expertise through the Colman Knight Advisory Group in Carlisle, Massachusetts.

Executive Summary

- It is important for financial planners to understand the basics of asset protection. Asset protection is a shield against unscrupulous lawsuits—not a way to hide from legitimate obligations.
- The history of asset protection through the legal system, including trusts, corporations, and insurance, goes back to ancient times.
- Recent U.S. and state statutes have significantly expanded options for asset protection.
- The three rules of asset protection are (1) do not own significant assets in your own name, (2) use multiple entities to own your assets, and (3) keep assets and the entities that hold your assets in different or in multiple jurisdictions.
- The first line of defense, which is limited, includes statutory protection and insurance.
- The second line of defense is owning separate assets through multiple entities, including trusts, corporations, partnerships, limited liability corporations and partnerships, foreign grantor trusts, and domestic asset protection trusts.
- The third line of defense is locating those entities in multiple jurisdictions.
- A hypothetical client situation is used to illustrate specific methods of applying this knowledge.
- In the future, informed planners will be those who understand their professional responsibility to help clients protect their assets.

The term *asset protection* has been in the popular press quite a bit during the last couple of years. While insurance provides a good initial firewall of protection, more and more consumers and financial professionals are coming to believe that relying only on insurance to protect assets is not enough. This article is designed to help both the novice planner by explaining the basics of asset protection and the sophisticated asset protection strategist by adding a few new tools to their asset protection toolkit. We will review the basics of good asset protection, such as qualified pension plans and homestead protection statutes, which may be sufficient for clients with minimal assets, to the more sophisticated strategies using multiple entities in multiple jurisdictions employed by the truly wealthy or those desiring more complex asset protection strategies.

Legal instruments to protect assets have existed since the beginning of civilization. Trusts were used in ancient Egypt, partnership documents have been discovered in Mesopotamia, and documents link corporations to fifteenth-century France, and limited liability companies (LLCs) have been used in Europe for better than a hundred years. In 1977, Wyoming became the first state to enact an LLC statute to facilitate business development in its state. In 1988, Revenue Ruling 88-76 recognized that a Wyoming LLC could be taxed as a partnership while having the asset protection of a corporation. Now, almost every state has LLC statutes, and since 1996 Delaware has had a Series LLC statute, providing a more complex form of LLC that we will describe below.

A similar situation is unfolding with asset protection statutes. Since January 2004, Oklahoma and South Dakota have enacted asset protection statutes, and if this trend continues, which we think it will, many more states will soon follow them. The story for domestic asset protection trusts is similar. Until 1997, asset protection was mostly the venue of creating trusts outside the United States. Then in

1996 Congress took up the issue and passed Internal Revenue Code Section 877, which made removing assets from the United States or contemplating renouncing one's citizenship to avoid taxes subject to immediate estate and gift taxation. Immediately upon passing of this tax act, Alaska—followed closely by Delaware and Nevada—passed domestic asset protection acts.

The activity of the states to create asset protection on a domestic basis has fueled interest in asset protection, while at the same time the federal government is cracking down on foreign transfers of assets. Recent tax legislation, dubbed the American Jobs Creation Act of 2004, has tightened rules on expatriates trying to escape U.S. taxation and seeking foreign asset protection, so we expect this area to occupy more time with financial professionals, press and our clients. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), which took effect in October 2005, also profoundly changes many asset protection strategies.

Let us make one thing very clear before we go further. We are talking about defending your clients' assets against frivolous or unscrupulous actions against them. *We are not suggesting in the slightest that these methods be used in an offensive manner to defraud and deceive legitimate creditors. First, in most cases fraudulent transfers are illegal, and second, courts have been aggressive in placing defendants in jail for contempt of court when creditor deception is suspected.* That being said, the cost to defend lawsuits has risen exponentially as the amount of litigation has grown. Old tools such as statutory protection, insurance, and self-insurance may not suffice in twenty-first century America. These are the reasons for asset protection.

With these words of encouragement, we now address the main rules of asset protection.

The Rules

Rule one: Do not own significant assets in your own name. First, having assets in your own name allows anyone to attach a judgment to the assets with very little trouble, especially real estate. Second, with some minor limitations, anything owned in your personal name can be attached and seized by a creditor. This means that if I own a car and someone is injured in the car, even if I did nothing wrong to cause the injury, theoretically the injured person can sue me for everything I own, including the car, the house, brokerage accounts, bank accounts, and my personal assets. By creating trusts, LLCs, S corporations, and so on, the only assets that can be taken in the same lawsuit are the assets owned within that entity, which in our example, would be, with any luck, only one or two automobiles.

Rule two: Use multiple entities to own your assets. The entities you can use to own your assets include trusts, corporations, partnerships, limited liability companies (LLCs), limited liability partnerships (LLPs), foreign entities such as foreign grantor trusts (FGTs), and domestic asset protection trusts (DAPTs).

Rule three: Keep assets and the entities that hold your assets in different or in multiple jurisdictions. There is a common myth that asset protection means putting your assets in entities located in a foreign country. While that is a part of asset protection, it is a small part. For the large majority of people, multiple jurisdictions can mean simply having entities domiciled in different states.

Rule four: Remember that the target is always moving. Here in the United States, laws change all the time, as does how courts interpret the laws. Our legal system relies upon an ever-expanding framework of case law that serves as a lens through which our laws are interpreted and applied. Our tax laws, which permeate and influence all commerce in America, offer a perfect example. Tax courts, appellate courts, and even the U.S. Supreme Court make changes to the tax law through legal decisions, as well as Congress initiating key changes. For example, limited liability companies did not really exist before the late 1980s, with the exception of Wyoming, but a 1988 Revenue Ruling has caused LLCs to proliferate since then.

First Line of Defense: Statutory Protection and Insurance

Original methods of protecting what you owned were simple: you hid it or locked it up. These methods, though, are of limited value except for tangible treasures like gold or silver. That is why our government has taken steps to provide rudimentary statutory asset protection.

Statutory Protection

Depending on where you live, you have varying amounts of statutory asset protection. Joint ownership with rights of survivorship between spouses creates asset protection from lawsuits in most states. Every state has a homestead protection act, which allows someone to protect a primary residence against creditors. The protection provided varies greatly from state to state: New York allows for $10,000 of exemption for individuals and $20,000 for married couples; New Hampshire allows for a $50,000 exemption amount. South Dakota, Florida, and Texas allow an unlimited exemption on a home. Massachusetts, however, limits homestead exemptions to $500,000 for claims arising after October 26, 2004. The Employment Retirement Income Security Act of 1974 (ERISA) provides for absolute protection of all qualified retirement plans. BAPCPA has extended the protection to the first $1 million of an individual retirement account (IRA), though generally an unlimited amount is protected in rollover IRAs. Many people, retired to Florida and with few assets outside of their pension plans, may already have all the asset protection they need.

For the rest of us, some planning is required. We might describe insurance and statutory protections as the first line of asset protection. It's a thin and sometimes unreliable line. To fully protect your assets, you need to take some additional action. A

specific asset-protection plan can be quite complicated, but the essential strategy is simple: ownership of your assets through multiple entities in multiple jurisdictions. Simple situations and clients with few assets can accomplish a first-line defense by living in states with unlimited homestead exemptions, combined with holding all assets as joint tenants with rights of survivorship, and keeping their funds in a qualified plan protected from creditors by statute. An IRA is given such protection in most, but not all, states. Of course, this ownership style has negative estate tax consequences for taxable estates and only works for married couples. For everyone else, more must be done.

Insurance

Proper insurance is one of the tenets of sound financial planning. When it works, insurance is a godsend. But insurance was never designed to eliminate all risk, and trying to do so means premiums that are prohibitively high. Insurance is a business and companies shy away from areas where the risk is too great, or they increase deductibles and limit coverage to minimize the loss. It is naive to believe that insurance alone is enough to protect a client's assets.

Second Line of Defense: Multiple Entities

This goes back to the old idea of not putting all your eggs into one basket. When your assets are separated, a lawsuit or attack on one entity does not put all of them at risk. You can only lose one egg at a time. Not only is it to wise not put all your eggs into one basket, but if you use some advanced asset protection techniques (like mortgaging free-and-clear real estate assets), you may not even lose your individual eggs. The multiple entities that we will discuss are trusts, corporations, partnerships, limited liability companies, foreign entities, and domestic asset protection trusts.

Trusts

We are most familiar with living trusts, testamentary trusts, irrevocable life insurance trusts, grantor retained annuity trusts (GRATs), charitable remainder trusts (CRTs), and charitable lead trusts (CLTs). One trust we seldom hear discussed is called a land trust—very useful, yet rarely used. These are grantor trusts where the beneficiary, not the trustee, controls the property. Land trusts can hold only real property or mortgages, and should not to be confused with revocable or irrevocable land trusts used for conservation purposes through conservation easements. [Editor's note: See Robin Underwood's article in this issue, "Conservation Easements: Making the Most of Your Client's Hidden Asset."]

With land trusts, the trustee can take one of four actions: sell, buy, lease, or mortgage, and these actions can be taken only upon written direction of the beneficiary. Another unique feature is that the beneficial interest is considered personal property. Judgments do not become liens against personal property. Legal matters are handled in accordance with the Uniform Commercial Code (UCC) rather than normal trust law. Currently only six states—Illinois, Florida, Hawaii, Georgia, Virginia, and North Dakota—allow for land trusts, but many other states allow for foreign trusts, so this is a useful option for many clients.

Corporations

We all know that corporations protect assets. But because of their tax complexities, we planners often breeze right over C corporations and typically recommend S corporations. What we often miss about C corporations is that while they have some of the lowest tax rates (currently the first $50,000 of profit is taxed at 15 percent), the current laws dealing with taxable dividends provide that, depending on what the shareholder's tax rate is, the dividends are taxed at a range of 5 to 15 percent.

The S corporation was created to have the tax protection of a corporation but to allow the income to flow through. There are restrictions, including limits on the number of shareholders and classes of stock, intended to keep S corporations as small entities. In recent years, limited liability companies began replacing S corporations. In response, there have been some rule changes for S corporations, so they will likely begin to be used more. Probably the biggest remaining advantage of S corporations is that their dividends are not subject to FICA tax, giving them some benefits over C corporations when used by professionals and many small-business owners who, when using a C corporation, would be subject to the Personal Service Corporation rules.

Partnerships

General partnerships do not make good asset protection vehicles because all partners are personally and jointly liable. But limited partnerships have become one of the most popular asset protection vehicles, in particular the family limited partnership (FLP), which differs from a limited partnership in that the ownership interests are all controlled by family members.

The most unique asset-protection feature of the FLP is that the limited partners can't really control the flow of cash. Suppose Junior, who owns a limited partnership interest in the FLP, gets into an accident or some type of trouble, and his creditors sue him. They could wind up with his share of the interest in the family limited partnership. The parents or grandparents, who control the FLP as the general partners, could decide they aren't going to distribute any money, even though the partnership has a lot of income. Instead, they could make loans to Junior. What results is that the creditor, who now owns the limited partnership interest in the FLP, winds up having phantom income (the tax liability without the cash to pay it). For the creditor, this becomes the worst of two worlds: a phantom-income generator. What hap-

pens in many cases is that the family ends up buying back those interests for pennies on the dollar. So it actually is a very good asset protection tool.

Limited Liability Companies and Partnerships

Limited liability companies were born out of the problem of double taxation of C corporations because there was no flow-through of gains and losses, and S corporations being too cumbersome, primarily because of the restrictions on who could own them. Partnerships, as we have seen, had general liabilities, and limited partnerships had a lot of problems with passive incomes. So in the late 1970s a new entity was created that was neither a corporation nor a partnership but a limited liability company.

Today, most states have passed the Uniform Limited Liability Act in one form or another. The limited liability company is a great entity with tremendous flexibility, and it is being used extensively in America now. The number of LLCs is increasing exponentially every year. It makes a great asset-protection tool because the owners, who are called members, can only lose their shares or units. They are not personally liable for actions of the company or other members.

A limited liability partnership is identical to a limited liability company except that the members can't sue each other. That's an important point. In the Arthur Andersen scandal, all those people who were shareholder partners wanted to sue each other, but they couldn't. Any partners who were not directly involved in the misdeeds with Enron and WorldCom would not lose their personal assets, except for their units in Arthur Andersen. Most large professional businesses such as accounting firms or law firms are LLPs. Not every state has adopted the law providing for LLPs, however, so there are some quirks with it. Nonetheless, that type of entity is growing exponentially.

Foreign Asset Protection

Two types of entities are used as an asset protection. One is called a foreign asset protection trust (FAPT). It is sold routinely in the classified sections of legal and business magazines. The other one is a controlled foreign corporation (CFC). We won't go into detail on either of these because they are usually related to doing business overseas.

In 1997, Congress passed an act to prevent U.S. citizens from benefiting from FAPTs and CFCs. It provides that if you move your assets overseas, you are going to have to pay the estate or gift tax immediately. The tax is due if you make a gift to a foreign trust or entity of over $60,000 and have a net worth of $500,000 or have made an average of $100,000 a year for the last five years. The IRS can also apply the tax if you contemplate renouncing your citizenship.

In 2004, Congress closed what they perceived as a loophole. The 1997 act allowed taxpayers to petition that the reason for renouncing citizenship was not mostly tax motivated and by that the tax could be avoided. The loophole in the system was that most of the time the Internal Revenue Service did not make a determination and the non-determination was viewed in the taxpayer's favor. Now, the non-determination is viewed as a tax avoidance.

There are practitioners still working with foreign grantor trusts, but their use is mostly for eliminating frivolous suits because of the cost to litigate rather than place assets in a trust that can withstand a lawsuit. Even so, the cost for doing so is high—between $10,000 and $50,000 to establish, and thousands more annually to maintain. Families with large assets and at high risk of litigation have successfully employed these devices to eliminate frivolous lawsuits.

Domestic Asset Protection Trusts

The same year that Congress passed laws limiting foreign asset protection, someone in the state of Alaska came up with the bright idea of offering domestic asset protection trusts. The state quickly passed a law allowing people to form a trust in Alaska that provided the same protection that had been offered by a foreign asset protection trust.

Following Alaska's lead, Nevada, Delaware, Rhode Island, and more recently Utah, Oklahoma (which is the first state with a revocable asset protection trust), and South Dakota also jumped onto the DAPT bandwagon. Missouri and Colorado have trust laws that are interpreted in such a manner to allow some asset protection against creditors, but they have not enacted statutes authorizing DAPTs as of the time this article was written.

So far it appears that these trusts offer the best of both worlds. The grantor can be the beneficiary and retain limited control. The grantor or trust protector can amend the trust. These are almost always grantor trusts, which means you don't have to have a separate taxpayer ID and file a return. The key to these is the protection they provide for the assets, particularly in Nevada, which would be our first choice as the state of registration. Once you put an asset into Nevada's asset protection trust, after 2 ½ years the state will not allow the trustee to distribute those assets under court order or to a creditor.

The U.S. Supreme Court has not ruled on whether people who are not residents of a state can use its asset protection statutes; people are worried that a New York court, for example, is going to put one of the parties to the trust in jail for contempt if they don't comply with a court-ordered distribution. So until there's a lawsuit, the issue is going to be up in the air. Since almost all asset protection trusts include a trust protector, which means you can amend them if your law changes, these trusts can be dissolved. So our position is, why worry about the Supreme Court overturning the state laws governing DAPTs if you can terminate the trust? Your client is in no worse position for having created a DAPT, and is in a much better position if the law stands up to a Supreme Court chal-

lenge.

Furthermore, under the new bankruptcy act, transfers of assets within ten years of filing for bankruptcy are regarded as a fraudulent transfer. As many may know, a professional who assists a client in making a fraudulent transfer can be subjected to criminal charges, so the timing and use of these trusts are very important. We would be more concerned with creating assets in the trust than dealing with the new onerous ten-year rule for most clients.

Our view of the future is that asset protection statutes will grow. Until most states adopt some form of asset protection statute, its growth will be limited unless either a statute will go before the Supreme Court and be upheld, or New York or some other state will accept the Nevada Trust or the Alaska Trust. Either event will cause an exponential growth in the demand for DAPTs, followed by the adoption of the entity by most states. With safeguards such as trust protectors, we think an increasing number of legal advisors will use them, so it is important to know that this option exists.

Third Line of Defense: Multiple Jurisdictions

Our last line of defense is to have the corporations, LLCs, and trusts established in different jurisdictions or states. Doing so adds an additional layer of complexity that usually blocks the path of anyone bringing a frivolous action against the entity. Why? Because the attorney bringing the action will have to deal with a court in another state, and unless the attorney is licensed in that state, he will have to employ co-counsel, which gets very expensive.

Applying the Knowledge

The following case study is designed to demonstrate possible ways to use the concepts we have described. It is not intended to set out "the solution," but to stimulate your thinking about many possible solutions. Asset protection is an intricate part of risk management. Every case will be different and will have various possibilities for meeting the client's needs; there is no one size that fits all.

For our case study, we're going to take what we believe would be a very average client for most financial planners. Assume that we have a husband and wife who own a successful business in Colorado (the state is irrelevant for this discussion). They own some rental properties and the real estate where the business is located. They are sole proprietors, so they use Schedule C to report their profit from the business and Schedule E for the real estate. They have asked you to assess their situation and take a look at their risk management.

Step One

After analyzing their situation, you tell your clients they need to form either an LLC or an S corporation to protect their personal assets from an action against the business. Because there appears to be significant profit in this business, you recommend they form an S corporation, owned jointly by the husband and the wife. You also recommend that they form living trusts to own the shares of the S corporation and execute new wills that "pour over" to the trust. That's it.

What are the advantages of your recommendation? First, the living trust will not give them any asset protection, but it will make the disposition of their estates private and avoid probate. Creating the S corporation will give them some very important liability protection because you have isolated the business. This would mean that a judgment arising from a lawsuit against the business would not attach to the real estate or their personal assets. You have also lowered their audit risk. An S corporation is income-tax neutral. The dividends paid from the S corporation are not subject to FICA tax, so they have an automatic tax savings. Minority interests in the S corporation can be gifted to the children, and the husband and wife can retain control. At the death of the clients, the recipients of the minority ownership interests may receive minority-interest and marketability discounts.

But you can do more.

Step Two

You advise your clients to put their real estate into a Virginia land trust. We prefer Virginia because it has excellent land trust law protection. The two other states to consider are Florida and Illinois. The downside of these two states is that Florida requires you to publicly disclose the beneficiaries of the trust and the volume of case law in Illinois gives some creditors the ability to pierce the trust. Land trusts are under-publicized but powerful asset-protection entities. The beneficiary of this land trust can be the husband and wife, or it could be their living trust. The trustee of the land trust will reside in the state of Virginia. That's it for step two.

What are the advantages of what you have done now? You have even more liability protection because you have isolated the real estate from the business and personal assets. The trust is income-tax neutral, so you are going to report it on Schedule E. There is no annual meeting with a trust. There is no filing with the state. A trust is one of the most beautiful privacy entities you can use because there is no public record. The only way to find out who is the beneficiary of a trust would be to subpoena the trustee. The interest of the trust can be gifted to the kids. The husband or wife can retain control. Upon death, the minority beneficial interest may qualify for a discount. And, best of all for asset protection, the beneficial interest is personal property.

Yet you can do still more.

Step Three

Next you will form a Nevada asset protection trust with a Nevada trustee. The beneficiaries of the trust can be the husband and wife or their Colorado living trusts that you created back in step one. That's all.

One of the features of Nevada asset protection trusts is that they are grantor trusts, so the clients can be both the grantors and the beneficiaries. The ownership of the S corporation and the land trust is transferred to the Nevada trust. So now you have the LLC and the land trust, owned by the Nevada trust, which is owned by the Colorado living trust(s).

This plan offers significant advantages. After 2 ½ years, all assets in the DAPT are unattachable by judgment creditors. It is income-tax neutral, it requires no annual meeting or filing with the state, and there is no public record of beneficiaries. Interests can be gifted to the children with minority discounts, but the husband and wife can retain control. The audit risk is still low, and you have not created anything that will put your client in a worse position if the Supreme Court would overturn the asset protection statutes.

But you can do even more.

Step Four

Now things begin to get really interesting. Up until now, the Virginia land trust has owned all the real estate. That included the rental properties and the real estate used in the business. In your next move, you will place each property in its own Virginia land trust. Then you form a Delaware LLC, which will now own the beneficial interests of the Virginia land trusts. A Delaware LLC is chosen because Delaware allows for a Series LLC, which allows one entity to own multiple assets and treat each asset as if it were in its own LLC; thus each asset in the LLC is protected. So far, only Delaware and Tennessee authorize this type of LLC. This LLC is inserted between the land trusts and the Nevada asset protection trust. The owner of the LLC is the Nevada asset protection trust. That's all for this step.

The primary advantage here is increased liability protection, because each parcel of real estate is isolated. Another nice perk is that the LLC return has a lower chance of a tax audit than Schedule E. This is still tax neutral, and all family members who receive minority interests receive discounts at death.

But we are not done yet—a truly informed planner can do even more than this.

Step Five

Next, you will form a C corporation in another state. We chose South Dakota because of its business-friendly attitude, no corporate income taxes, low annual fees, and minimal reporting requirements. The owner is either a Nevada asset protection trust or the living trust of one of the spouses. To receive the benefits outlined below, Treasury regulations require that the other spouse not be a director, officer, shareholder, or employee. The corporation could provide services to the Colorado S corporation, which owns the business, as an independent contractor. This corporation could also manage the rental property. But just to give you a flavor, we create an LLC to manage the properties, which means it would be the first entity sued if something happened to the properties. We locate this LLC in Wyoming due to its inexpensive fee structure. The Wyoming LLC receives compensation for acting as a management company for the real estate properties.

This provides further advantages. Liability is further removed from the business. Any discretionary income is funneled to a state with no state income tax and is taxed federally at the lower corporate tax rate. Please note that not every situation will fit this scenario. There are some very precise regulations that must be met to make sure the income of the corporation is considered to be earned in South Dakota, and therefore not subject to Colorado state income tax. For purposes of this example, we are assuming those conditions exist.

What will all of this cost? The initial costs to create all of these entities can span from a few thousand dollars to 30 thousand dollars and up, depending on the number of entities and jurisdictions. The annual costs include any state filing fees, the preparation of tax returns, registered agent or trustee fees, costs associated with maintaining any required local office, and any state and local taxes. Designing asset protection plans such as these requires some specialized knowledge, attention to detail, and careful evaluation of what each individual client needs. It will mean that you need the input and assistance of a competent attorney and tax consultant. But the combination of savings and protections you provide will probably create a life-long client.

The Future of Asset Protection in the Planning Process

In today's complex environment, the need for asset protection planning is greater than ever. This is why the popular financial press continues to feature articles addressing asset protection and why financial planners need to know the latest tools and concepts before their clients initiate the discussion.

Currently, if you live in any of the nine states that have enacted asset protection statutes and you are not suggesting them to your clients, you are probably committing malpractice. In the future, we predict that sophisticated strategies such as the ones we have described will become as ubiquitous as the living trust is today. In fact, we would not be surprised if, in the relatively near future, not knowing about these techniques will constitute malpractice on an even broader scale.

The informed planner of the future is one who will be able to design a road map to make these strategies simple to follow and who will understand the professional responsibility to help clients protect their assets.