

Small Business TodaySM

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Cover Your Assets: How to Protect Yourself in an Uncertain World

Protect Your Assets!

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This newsletter is a companion to the four-part lecture series we presented to benefit the Acadiana Education Endowment.

Asset protection is a sometimes controversial area of the law, even though it has been popular with the wealthy since trusts and corporations were first invented. Because of this popularity, an entire seminar industry has sprung up endeavoring to sell asset protection tools to the masses.

Purveyors of these seminars promise to rid you of lawsuits, eliminate taxes and make you invisible to creditors—if you buy their products. Unfortunately, such extreme claims give many people pause when we discuss the subject of legitimate asset protection.

You may be among those who doubt the legitimacy of such planning or may believe it can only benefit you if you are wealthy. But assuredly, asset protection planning is no longer just for the rich, and it can be a helpful adjunct to starting a business and estate planning.

In my view, asset protection is not something you can buy ready-made. Instead, it involves assessing and balancing the risks that your lifestyle and business create against the nature and quantity of your assets. Most importantly, a well-designed asset protection strategy takes into account your goals and plans for the future, including where you want your assets to end up after your death.

For most people, the most obvious asset protection plan is to purchase property and casualty, life, health and disability insurance. Because insurance is generally affordable and very beneficial, it certainly should be the starting point of most asset protection strategies.

But insurance alone may not be enough for three reasons. First, insurance policies are limited in the benefits they pay. Second, they contain exclusions. Third, some risks may be uninsurable or the cost of purchasing such insurance may be exorbitant.

Using casualty insurance as an example, let's suppose you are sued for negligence in a car accident. Suppose further that the cost of defending yourself is \$50,000 and the court finds you owe the plaintiff damages of \$75,000. If your

automobile liability policy has limits of \$100,000, you would be forced to pay the plaintiff \$25,000 out of your own pocket.

Or, suppose coverage for the claim is excluded under the terms of your policy. If so, you may only find out about the exclusion when your insurer challenges its responsibility for payment of the claim at trial. If your insurer is successful, not only are you out the \$125,000 involved in defending yourself in the plaintiff's lawsuit and paying your damages, you would also pay your expenses to fight your insurer.

Finally, what if no regular carrier will insure you because you represent too great a risk? Your only alternative would be to find a minimum coverage policy through a high-risk pool or surplus lines carrier, premiums for which policy will be many times the cost of a regular policy. And, any claim larger than the minimum policy limits would, of course, be your responsibility to pay.

At this point, some people tell me they would simply go bankrupt to avoid paying the damages. Well, first, the only way to go bankrupt is if you really don't have the money to pay. A total discharge or Chapter 7 bankruptcy takes everything you have, throws it into a pot and pays out everybody you owe, allowing you to keep a little bit of your house, a really run-down car and your wedding rings. Not much fun, but the law reasons that you will have enough to start over.

(Okay, I can hear many of you thinking: "I'll just transfer my stuff to my brother-in-law so I can go bankrupt and get it back after the lawsuit." No, merci! Such transfers, sometimes called "poor man's asset protection," are a fraud on the court (read: "jail-time") and gift taxes must be paid each time the stuff is transferred—assuming, of course, your brother-in-law decides he wants to give your stuff back.)

Second, a total discharge in bankruptcy is not as easy to get as it used to be. You could end up in a Chapter 13 restructuring bankruptcy that will simply rearrange the debt, including your damages for the lawsuit, allowing you to pay it out over several years.

Finally, why would you think of bankrupt as your only backup plan? With a little foresight and preparation, you may be able to manage your excess risk and keep your stuff.

To help manage risk not covered by insurance, you may consider using limited liability entities, such as corporations or L.L.C.s. The protection provided by incorporation may be available to you even if you work for someone else, depending upon your specific situation. Sometimes it may even be advisable to use

Did you know?

- According to the *Las Vegas Business Press*, 80% of the 71,036 new business entities formed in Nevada in 2004 were out-of-state corporations. Nevada is the third largest jurisdiction in terms of new incorporations per population density.

— Source: Steven Mihailovich,
March 21, 2005

- In 2001, the U.S. Insurance Industry was worth approximately \$1.6 trillion or 10 times the U.S. market for legal services.

— Source:
http://www.bizstats.com/market_sizes.htm

more than one company for additional liability protection, to increase your privacy or to reduce your tax burden.

On the other hand, managing a corporation can seem cumbersome to the uninitiated, and incorporating and maintaining your company also involves legal costs and other fees. Moreover, keeping the liability protection you are paying for using a corporation requires continuing effort.

Even if you are incorporated, the company must be run in a business-like manner or else risk losing its liability protection during a lawsuit. For a further discussion of how corporations and L.L.C.s work, please see my newsletter dated November 17, 2006.

Trusts are another means of achieving liability protection, privacy and possible tax advantages. In its simplest form, a "settlor" or "donor" contributes

assets to a trust. Those assets, called the trust "principal," are owned by the trust and not the trustee, donor or even the "beneficiary." The "trustee" is the person or entity charged with administration of the principal and ensuring that the beneficiary receives the benefit of using it according to the terms of the trust instrument.

One very interesting type of trust is the "spendthrift" trust. A spendthrift is defined as a person who wastes money, often large amounts of it. Therefore, this type of trust was created to benefit such a person and keep him from mortgaging or otherwise losing the principal to a creditor. If you want to ensure that a

For more information on this subject, please see these websites—

- ◆ Insurance Basics:
<http://en.wikipedia.org/wiki/Insurance>
- ◆ Article about Nevada Incorporations:
<http://www.lvbusinesspress.com/articles/2005/03/21/news/news08.txt>
- ◆ I.R.S.'s warning about "abusive" trusts:
<http://www.irs.gov/businesses/small/article/0,,id=106549,00.html>

child or elderly parent always has enough to live on, for example, this type of trust may be a way to accomplish that goal.

Trusts have been around for a long time, and many generations of clever lawyers have found new and creative ways to use these devices. Today, however, many trust arrangements are regulated and carefully scrutinized by the I.R.S. It is very important, therefore, when planning, running or benefiting from a trust you seek the advice of an attorney that is not only a tax expert, but also an expert in wills and estates to avoid running afoul of complex federal rules.

The final type of asset protection device we will address here is the now-infamous "offshore" corporation. Offshore corporations are called that because many "tax havens" where these entities are formed are in the Caribbean or other locales outside the U.S. But my favorite "offshore" location is actually Nevada.

Two major benefits of incorporating in Nevada are tax benefits and privacy. Don't believe anyone who claims you can avoid all taxes by incorporating in Nevada. Not true. But you can avoid corporate income tax, franchise tax, taxes on corporate shares and possibly some personal income tax by incorporating there. That is because Nevada does not tax those things. You will still have to pay federal income taxes, however, as well as taxes to states where your business operates or

earns revenue.

To me, the real selling point of Nevada incorporation, however, is privacy. If you want to avail yourself of the protections afforded by U.S. law but don't want others to be able to find out how much money you have, what properties you control, etc., you can't beat Nevada.

When you have a properly formed and operated Nevada corporation, virtually no one can find out who or how many shareholders there are, how much stock was issued, what are the assets, capitalization or value of the company, who the current officers and directors are or even where the stock ledger is.

I do emphasize that proper formation and operation are key to availing yourself of these protections, so beware of fly-by-night incorporating companies. Also, this is not something you should attempt to do yourself. Find a knowledgeable lawyer who can educate you about what is required to make your Nevada corporation work, what you can and cannot use the corporation for, and can give you an idea of the costs and hassle-factor associated with running one of these entities. They are not for everyone.

In conclusion, there are many ways to protect yourself from the risks of daily living. Some are more complicated and expensive than others. But if you think you may benefit from asset protection, be sure to consult an attorney who can analyze your situation, help you understand the costs and complications of various alternatives, and tailor a plan that will fit your needs, lifestyle and level of business sophistication.

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