

TOOLS OF WEALTH



USING THE LAW TO MAKE MONEY

ELEVEN

REAL CORPORATE PROTECTION

By Lee R. Phillips, JD

One of my students called and stated that he had solved the asset protection problem. He was going to establish a C corporation, and then put everything he had into the corporation. He stated that if everything was owned by the corporation, then when somebody sued him, they couldn't get anything. I had to do a little explaining to convince him his plan wouldn't work.

Corporations were created to protect the investors (stockholders) and managers (officers and directors) from liabilities that might occur because the corporation was doing business. Congress created the protection to encourage people to fund and run companies. You certainly wouldn't want to be liable for the stupid things Enron did, just because you had purchased stock in Enron. Actually, you were liable, but only up to the amount of money you invested in the stock.

In many respects, the corporations you are dealing with are different than the Wall Street companies. Your corporations and limited liability companies (LLCs) are "closely held." When you set up a corporation or LLC, you own it alone or maybe with a couple of other people. If you do it right, your closely held corporation will give you a liability shield and protect

you from the activities of the corporation, just like a big corporation protects its officers, directors and shareholders. Yes, in your corporation you will not only be a shareholder, you will be an officer (president) and director of the company. That means you may be exposed to a lot more liabilities than the Average Joe shareholder, because if somebody can "pierce the corporate veil," the officers and directors become liable. The shareholders are almost never held liable. For purposes of this article, we will assume that you have taken care of all the corporate formalities and the "corporate veil" will hold when you are sued. How to take care of all of the corporate formalities and protect the veil is the topic of a later article.

By the way, it doesn't matter whether you have a C corporation (a corporation taxed under chapter C of the IRS Code), an S corporation (a corporation taxed under chapter S of the IRS Code), or an LLC, the asset protection shielding for each individual owner (shareholder or member) will be the same against activities performed by the company. However, the asset protection shielding for each individual owner against non-company related activities performed by any other individual owner or



LEE PHILLIPS
SHARES THE
LEGAL TOOLS
OF WEALTH
WITH YOU

GOT QUESTIONS?

What are your needs, concerns, or challenges?

Email Lee with questions you would like to see answered in this newsletter.

Email: info@legalees.com

IS YOUR MONEY SAFE? (CONTINUED ON BACK)

By Kristy Phillips, JD

Traditionally bank failures have been considered a "rare occurrence" that few of us, born after the Great Depression, had to worry about. So far this year eleven U.S. banks have failed, and more failures are on the horizon as the industry copes with the consequences of loose lending standards and bad decision making. The likelihood that these will not be the only bank

failures this year is evident in the FDIC's announcement that 117 banks are on its "problem list" of troubled institutions. That's the most that have been on the list since 2003, and more are expected to join the list as credit problems worsen, according to FDIC chairman Sheila C. Bair. With more than 8,000 banks operating in the United States, chances are good that your bank will not be among those that fail. But it is a good

idea to take steps to protect your money.

The essential first step is to make sure your deposits are fully insured. Given the current turmoil in the banking industry, there is no good reason you should leave a single dollar uninsured by the FDIC or the National Credit Union Administration.

The second step is to check out the health of your bank. You can



REAL CORPORATE PROTECTION (CONT.)

even activities performed by himself or herself will be very different if an LLC is used or a corporation is used.

The student that was going to protect everything by putting it into a corporation didn't understand the purpose of the corporation. The corporation is only designed to put up a corporate shield and protect the people (officers, directors, and stockholders) behind the shield from liabilities that occur as a result of the corporation doing business. Stated another way, if the attack comes from the company side of the shield, then the people behind the shield are protected. However, if the attack comes from behind, the corporate shield doesn't protect the individual under attack. A shield only protects you from arrows shot at you from the front where the shield is between you and the shooter. Arrows shot from the rear will not be stopped by the shield. Business or corporate activities are occurring out in front of the shield, personal activities are occurring behind the shield. If the attack comes from the personal side of the shield, all of your assets are at risk, including your ownership in the corporation or LLC.

To expand on this point, if somebody slips and falls at the business office, the shield will protect you. The attack (lawsuit) will come from the corporate side of the shield. The corporate assets will be exposed, but your personal assets will be protected. If a kid breaks his neck on the trampoline

in your backyard, the corporate shield won't protect you. The kid jumping on the trampoline isn't a business activity of the corporation. The attack is coming from behind the shield, and everything you own, including your stock in the corporation or membership in the LLC is at risk.

The only way to protect yourself against an attack from the back of the wall is to carry a lot of insurance. Congress has never given us a shield to protect us against our personal problems. Look at beefing up your homeowner's policy, health insurance, and auto insurance. Make sure you have a big umbrella policy. The cost of beefing up your insurance protection may be less than the corporate filing fees in some states, so effectively it doesn't cost any more to protect your backside (ass-ets) than it does your front side.

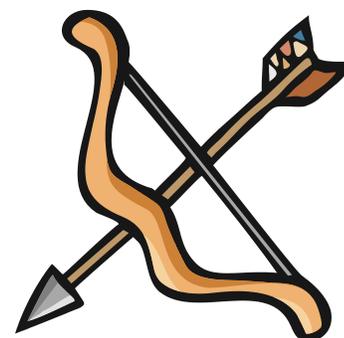
If the attack comes from the back, i.e., you are personally sued or go bankrupt, what happens to the assets you own? Obviously, they are all open to your creditor. A revocable trust (land trust or estate planning trust) won't help. What happens if the attack is made on one of the other owners of your closely held business? (Those owners are often your children or other family members.) Will you lose your business assets, just because they are attacked? Advanced planning can help protect your company's assets from an attack from the back of the shield.

It is a common asset protection technique to hold

assets in a land trust. If you are attacked personally, the land trust will not give you any protection. (See the last issue of Tools of Wealth.) It is also common to hold one or more properties in a corporation or LLC entity. Holding a property in an entity will protect you and your other properties from problems associated with the property that is owned by the entity.

For asset protection purposes, it is a good idea to hold each property in a separate entity rather than your own name or a land trust. Obviously, there is a limit to the number of entities you can afford and can manage. (Most people can't effectively manage any more than 3 to 6 entities.) If you have a lot of properties, logically group them into a limited number of entities. The question is, what entity should you use to hold the properties? You should probably never use a C corporation. That leaves limited partnerships, limited liability companies, and S corporations.

Let's assume that you own two apartment buildings. One apartment building is held in an LLC taxed as a partnership and the second apartment building is held in an S corporation. (Actually, the membership interests in the LLC and the stock in the corporation should be owned by your living revocable trust to avoid probate problems and estate taxes when you die.) In either case, if a tenant slips and falls, the tenant will have to sue the entity that owns the building, not you. The attack is coming



A shield only protects you from arrows shot at you from the front where the shield is between you and the shooter. Arrows shot from the rear will not be stopped by the shield.



REAL CORPORATE PROTECTION (CONT.)

from the front (company) side of the shield. Assuming the corporate/LLC shield holds, the most the tenant can get is the assets of the entity that owns the building. Your other assets, including your ownership of the entity that owns the other apartment building, will be safe. (Even though your trust owns both entities, for lawsuit, creditor, and tax purposes, you are considered to be the owner. The trust only gives you probate and estate tax protection.)

What happens if the attack comes from the back (personal) side of the shield against you or one of the other owners of the LLC and corporation, and the attack is successful? The spoils of the suit will include your stock in the corporation that owns the apartment building, and your membership interest in the LLC that owns the other apartment building.

As to your stock in the S

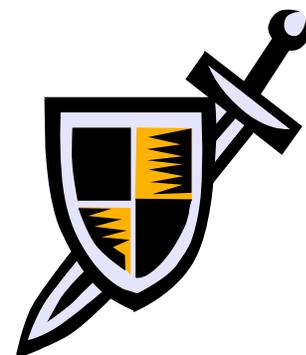
corporation, the creditor (lawsuit winner) gets the stock and owns the office building. They throw you out as officer and director, and they run the show. It is their building. The creditor also gets your membership in the LLC – sort of.

With a membership interest in an LLC or a limited partner in a limited partnership, including a family limited partnership (FLP), the creditor has to get what is called a “charging order” to come against the entity. The charging order limits the creditor to only being able to receive the financial benefit of the owner’s interest in the LLC or limited partnership. It does not give the creditor any voting or management rights. This is very different from being able to seize the stock in a corporation and have all the voting rights and management rights. If the LLC document is written properly, the management of the LLC or partnership is intact and can basically make life miserable for the

new member. You are still in control. You can siphon off all of the income and tax benefits before the creditor gets anything as a result of his “ownership” in the LLC or limited partnership. Yes, you can shift tax burdens to the creditor without ever giving the creditor any money. Basically, you still have the apartment building as an asset.

It is subtle, but the charging order concept is a powerful asset protection tool. Can you see the difference in the corporate outcome and the LLC outcome? The attack may come from someone piercing the corporate veil, personal lawsuit, illness, divorce, or any one of a dozen other disasters. You need to plan for the personal attacks from behind the shield, as well as the business related attacks from the front of the shield.

The concept of charging orders is misunderstood, even mythical, and often not fully utilized. My next article will dissect the laws of charging orders and show you how you can get the most mileage out of them. ■



You need to plan for the personal attacks from behind the shield, as well as the business related attacks from the front of the shield.

DON'T MAKE THIS COSTLY MISTAKE

By Kristy Phillips, JD

When setting up your retirement fund, you can save your family money by avoiding naming the wrong beneficiary. I know that Lee is emphatic that you fund your trust. Funding the trust means that you place all your assets in the name of the trust. However here is one very important caveat or warning! When you are dealing with your retirement accounts, naming your estate or your trust as a beneficiary of your retirement account is a costly mistake. Don't do it, and if you already have, take steps to change it today.

Why? Because after your death, each individual designated as a beneficiary

of your retirement account can choose to allow your retirement funds to continue to grow tax deferred. Beneficiaries are required to make withdrawals based on their own estimated remaining life spans. If the trust is the beneficiary, all of the trust beneficiaries must make withdrawals based on the age of the oldest beneficiary. This means many decades of tax benefits that could accumulate for younger beneficiaries will be lost. Or worse yet, the trust may be forced to immediately distribute the IRA funds, thus losing the possibility of continued tax advantaged growth and triggering a possible disastrous income tax problem for the beneficiaries.

For instance in my family, my sister was born when I was sixteen. If my parents name the trust as their retirement account beneficiary, my sister will lose sixteen years of growth on her portion of the retirement estate.

Forgetting to name a beneficiary at all is a total disaster. Retirement assets named as estate beneficiaries will be subject to probate. Probate is not only time consuming and expensive, but creditors will be able to make claims against your assets during the probate process. Plus there will be a big tax bill. Check your retirement funds now to make sure you are not making one of these mistakes. ■

LEE R. PHILLIPS

LegaLees Corporation
556 East 1400 South
Orem, UT 84097
Phone: 801-802-9020
Fax: 801-802-9157
Email: info@legalees.com

LEGALEES

CORPORATION

U S I N G T H E L A W T O M A K E M O N E Y

IS YOUR MONEY SAFE? (CONT. FROM FRONT)

do this by visiting Bankrate.com "Safe & Sound" ratings.

Finally, if you hold more than \$100,000 at a single bank, I'd suggest you visit the FDIC's Electronic Deposit Insurance Estimator at www.fdic.gov/edie. It is an online calculator that will help you to be sure your deposits are fully insured. As you probably know, the basic insurance limit on bank deposits is \$100,000 at a single bank. If you know the rules well, however, it is possible for a single person to extend that coverage to more than \$500,000 at one bank. This can be done by utilizing multiple account ownership categories. For example, you can be insured for up to \$100,000 for a single account and another \$100,000 in a joint account with a spouse or someone else. Other ownership categories include payable-on-death accounts, trust accounts, and corporate accounts. Also, there is a \$250,000 insurance limit for IRAs and certain other retirement plans containing bank deposits, rather than mutual funds annuities or other securities sold through a bank.

If you wake up one morning to find your bank taken over by the FDIC. What do you do? Resist the urge to rush down to the local branch and wait in a long line as folks did when the FDIC seized IndyMac Bank in July. If your deposits fall within the insurance limits, there is no reason to panic. And if you're over the limits, it's too late to act. Depending upon the circumstances, uninsured deposits may or may not be accessible right away. But once the FDIC has taken over, that decision has already been made. According to a recent FDIC consumer newsletter, here is what happens when a bank fails and the FDIC takes over: In most cases, the FDIC makes insured funds available on the first business day after the bank is closed. And often, funds are available before then through a bank's ATM network.

The FDIC tries to find a healthy bank to quickly buy rights to assume the insured deposits. Depositors automatically become customers of the assuming bank, and offices open under the name of the new bank. If the FDIC cannot find another

bank to buy the insured deposits, one of two things can happen. One, the FDIC can transfer assets to a newly created bank it runs until a buyer is found. The other alternative is the FDIC can issue checks up to the insured limits directly to depositors. That process usually will not take more than three business days, says the FDIC. Some types of deposits may take longer to deal with. These include accounts linked to a trust, employee benefit plan deposits, and bank CDs bought through a deposit broker.

In a takeover, you will have access to your funds up to the insured limit, but possibly not the rest. For instance, if you have a single account with \$105,000, you have access to \$100,000, but the remaining \$5,000 may be tied up for several years as the FDIC tries to sell the failed bank's assets. And even then, you may not get all your money back.

Check today to make sure your savings are FDIC insured. ■

