Protecting Business Wealth From Creditors

If you're a business owner, you've likely worked long and hard to achieve your goals. It would be a shame if creditors were able to reach your assets before you've transferred wealth to the younger generation. Fortunately, there are several options to consider that may provide asset protection.

The Need For An Asset Protection Plan

Before digging deeper, you should start with an understanding that an asset protection plan is needed to insulate your estate from the claims of creditors and lawsuits. The first lesson to be learned is easy: Don't think this can't happen to you. In fact, no one is immune.

When you create an asset protection plan proactively, you add a layer of protection before any claim or lawsuit arises. This can deter creditors and possibly thwart the seizure of assets. The sooner you act, the better.

There are, of course, various strategies you might employ based on your circumstances. Some popular ideas revolve around the form of business ownership and the use of trusts.

3 Forms Of Business Ownership

Depending on the structure of your business, you may have adequate protection from creditors, minimal protection or none at all. Thus, you might consider changing the ownership structure to create a corporate shield. Let's briefly review the three primary forms of ownership:

C Corporation. Generally, a C corporation provides limited liability exposure to the personal assets of its principals. There's no personal liability for corporate debts, contract breaches or personal injuries to third parties caused by the corporation or its employees. So a creditor can't seize your personal assets if the corporation can't pay its bills. This is a distinct advantage over traditional partnerships.

But be aware of an exception for certain personal services. For example, a physician might be held personally liable for damages incurred while performing services on behalf of a medical practice. In other situations, personal liability may be attached if the corporation has no significant assets and doesn't really act as a separate entity.

S corporation. With an S corporation, income and losses are passed through to shareholders on a personal level, thereby avoiding "double taxation" faced by C corporations. Like a C corporation, however, shareholders benefit from some corporate liability protection, albeit with additional limits as to the number and type of shareholders, allocation of profits and losses among shareholders, and the type of stock that may be issued to investors. For many business owners, an S corporation is the preferred choice.

Limited Liability Company (LLC). An LLC operates much like an S corporation without some of the extra formalities. Significantly, LLC principals are afforded the same liability protection as those in a C corporation, along with the favorable "pass-through" tax benefits available to an S corporation.

Note that filing requirements and creditor protections for LLCs may vary from state to state. Nevertheless, state laws generally protect personal assets of LLC owners from claims based on LLC activities.

Trusts And FLPs

One of the tried-and-true methods for protecting assets from creditors is to establish a trust and then transfer assets to it. The trust is managed by your designated trustee for the benefit of the trust's beneficiaries.

Trusts come in a wide range of shapes and sizes. An "inter vivos" trust is created during your lifetime while a testamentary trust comes into being upon your death through a provision in your will.

The types of trusts are too long to describe here, but they may be divided between revocable and irrevocable trusts. As the name implies, revocable trusts generally permit you to change beneficiaries and make other modifications. With an irrevocable trust, you concede full control. From an estate planning perspective, an irrevocable trust is advantageous because creditors can't touch assets you don't control.

Similarly, a family limited partnership (FLP) may be a viable approach for providing protection against creditors as well as tax benefits. With an FLP, a business owner transfers assets to other family members (the limited partners) without relinquishing full control of the operation. Any subsequent earnings are taxed to the family members, so if they're in a lower bracket there may be an additional tax-savings benefit.

Furthermore, FLP shares may be discounted in value because there's no public market for the shares. This enables the owner to shift even more business assets to the younger generation.

Assess Your Options

An asset protection plan is essential for business owners who are seeking to preserve and ultimately transfer wealth. Keep in mind that, for these strategies to work, you must implement them at a time when there are no pending or threatened claims against you. Otherwise, you may run afoul of fraudulent conveyance laws. Discuss your asset protection options with your estate planning advisor.

Weinstock Manion

1875 Century Park East, Suite 2000
Los Angeles, CA 90067
(P) 310 553-8844 | (F) 310 553-5165
www.weinstocklaw.com