ASSET PROTECTION COUNCIL™

The Key Concepts of Protecting Real Estate

(Modern Asset Protection Planning using *The Bridge Trust®*)

Introduction to Protecting Real Estate

Real Estate is one of the most important, and most difficult assets to protect. Why? Because real estate cannot just be picked up and moved away from a lawsuit like cash and liquid assets can. Nevertheless, after working with thousands of clients over the past 22 years, I can assure you that real estate can in fact be protected just as securely as other assets if you understand the **Key Concepts of Protecting Real Estate** which I will outline in this paper. Asset Protection is important for everyone, but for real estate investors it is even more critical because you have both more risk related to owning real estate and you also have easily identifiable real estate assets. Real estate is also one of the most heavily litigated areas of the law. Because of that, without asset protection, you are literally a sitting duck for a lawsuit.

Concept #1: Equity & Cash Flow are what matter (FMV is not!)

Real Estate almost always has debt associated with it. While this is not always true, certainly for most people it is true. What this means is that a building worth $3.5 million dollars, with $3.2 million dollars of debt actually has less net value to the owner than a building worth $650,000 which is paid for. There is saying in the business world which goes:

"Gross is vanity, net is sanity and cash is king!"

This applies equally to real estate. The gross value of your properties is vanity, the net equity is your sanity and your cash flow is king. Let me give you a real-world example.

I have one client who has a $25 million-dollar real estate portfolio; however, he has over $20 million in debt. So, the GROSS VALUE of the real estate sounds very impressive at $25 million. The sanity number is really the NET VALUE of the real estate which is only $5 million after all the debt is paid back – still pretty good.

However, here is the sticky part; the property does not have enough income to carry the debt – so the CASH FLOW of my client is negative by about $100,000 a month! Remember "Cash is King"! In this case my client has a negative cash flow of $1.2 million a year. So, unless that portfolio is increasing in value by over $1.2 million a year, or they can improve the cash flow significantly, that client is actually losing money the longer they hold the position! More than a few real estate investors learned this lesson in the crash of 2008!

Why is this important for Asset Protection? Because, if you have a judgement creditor looking to satisfy the judgement, that creditor doesn't care about the gross value of your real estate – they care about the net equity they can get from you today. They also care about the cash flow, because if it is negative like my client above, then the net equity may be completely gone by the time the creditor ever gets to the property. This is especially true when we make it difficult to reach by implementing the strategies we discuss below.

What this means for you when considering how to protect real estate is that DEBT can be effectively used to protect the value of your real estate by reducing your equity and making your property less attractive to a judgement creditor. This concept; however, is just a part of the full picture when using Asset Protection strategy to protect your real estate.

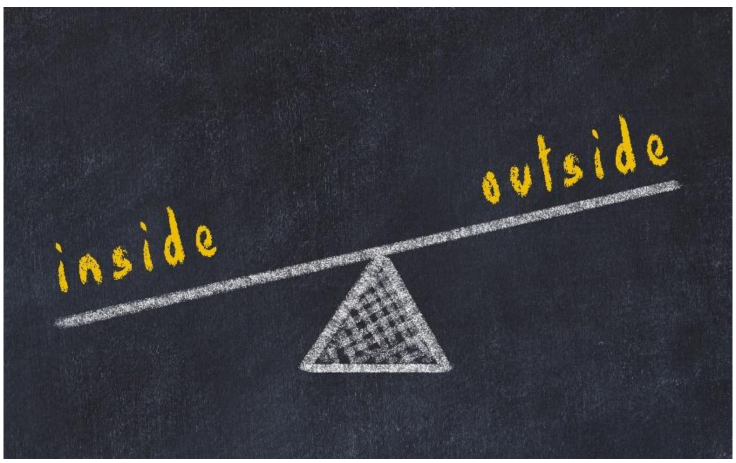
Concept #2: Inside vs. Outside Liability

What is the difference between ***inside liability*** and ***outside liability***?

Inside Liability refers to liability which is created inside the property itself. Examples would be a fire on the property which injures a tenant, or a pool that causes a death. These liabilities are *directly related* to the property itself. Thus, they are *inside* to the property.

These liabilities are *usually* covered by insurance, which should be considered the first line of defense for an inside liability; however, be careful, there are many reasons insurance is often not enough to consider yourself completely insulated.

Outside Liability refers to liability which has nothing to do with the property, but rather is related to the owner of the property. Examples would be a car accident which exceeds the property owner's insurance limits, or a personal guarantee on a business deal which is being called. These liabilities have nothing to do with the property and are outside of the property but since they are against the owner of the property, they can still put it at risk. These liabilities are often not covered by insurance and the risk they create can threaten the value of the real estate even thought they had nothing to do with the real estate itself.



SOLUTION: To address both types of liability, the first level solution is to create a ***Limited Liability Company (LLC)*** to hold your property. This does two important things:

1) Isolates the inside liability to a single property or group of properties; and
2) Insulates the real estate inside the LLC from an outside liability

This solution and how it works in conjunction with further concepts and is a fundamental building block of the full strategy as we will see.

Concept #3: Separate the Risk from the Assets

Life has risks and the potential for liability (inside and outside). This concept focuses on separating the ***risk*** from the ***assets*** to the greatest extent possible. This is the "***designated driver***" concept. By designating a sober driver, we can isolate the risk for the rest of the guests who decided to have a few drinks at the Christmas party. We do the same thing with Asset Protection, we identify and isolate the risk from the valuable assets and make sure they are not in the same place.

Consider a medical doctor who owns an office building which is worth $1 million. The doctor's risk is mostly in the practice where they have employees and see dozens of patients every day. The office building, on the other hand, doesn't create too much risk on its own, but has a significant value of $1 million.

The mistake many people have made, and continue to make, is to have the office building owned directly by the medical practice. This puts the valuable asset in the same place as the potential risk. If the doctor had a liability arising from their practice, a judgment holder could easily reach into that practice and take the $1M value of the office.

SOLUTION: The solution is to put the office into its own separate LLC. The LLC is not subject to the liability of the practice which creates the needed protection. This has the additional benefit of creating a positive tax effect since the doctor would pay the LLC rent for the use of the building, which is deductible by the practice. That rental income would be offset by the expenses of the building as well as the depreciation and would likely create no additional income and may even create an excess deduction!

This concept can be used anytime it is possible to separate the risk of an activity from the value of other assets and is a fundamental concept of protecting all of your assets.

Concept #4: Create layers of protection

If you have ever lived in a cold climate, you know that the best strategy to keep warm, while staying flexible to changing conditions is to layer your clothing. A base layer, a mid-layer and an outer waterproof layer.

This layering concept also works extremely well for protecting Real Estate. The base layer is the Limited Liability Company (LLC) we have mentioned already. But a base-layer alone is almost never enough to keep warm or to protect your real estate.

To add to your real estate protection, you want to create a mid-layer. Your mid-layer is your real estate holding company. Your holding company can hold individual LLC's which in turn hold your various properties. It can also hold non-real estate assets, such as excess cash and securities, or even passive-real estate investments in which you are a limited partner or a member of another LLC.

Adding a holding company has several significant benefits:

1) You can consolidate your tax reporting down to just one return with all you real estate and investments.
2) Your underlying LLC's may be single member, with the holding company as the only member. This allows you to elect to make them disregarded entities for tax purposes and eliminates the individual tax returns for each LLC, thus reducing your work and accounting expenses. Since the single member LLC is in turn owned by a multi-member holding company the vulnerability usually associated with having a single member LLC is eliminated.
3) The holding company can include other family members or business partners and is a great tool for estate planning.
4) Management of the properties may be consolidated into a single legal entity.
5) By diversifying your jurisdiction and choosing a State with favorable laws (like Nevada, Wyoming or Arizona) to create your holding company you increase the overall protection of your plan.
6) The holding company also allows for a smooth integration of your final "waterproof" layer of asset protection called *The Bridge Trust*®, which will be discussed fully in the next concept.

There are different legal options for your holding company including a master LLC, a Limited Partnership, and even a corporation. For my clients, I almost always recommend using either an Asset Management Limited Partnership (AMLP), or in some limited cases a Master LLC. The reason I recommend an AMLP is because of the statutory distinction between the General Partnership interest and the Limited Partnership interest, which has significant legal benefits, particularly when integrating your holding company with the final layer of planning - ***The Bridge Trust*®**.

Why I don't recommend using a Corporation as your holding company?

Corporations (C or S Corp) are not recommended for use as holding companies because the shares of a corporation are considered an asset by a court and maybe seized by a creditor. This is not true for partnership or membership entities like LPs and LLCs which restrict creditors to a charge against the member's interest (called a "Charging Order") and do not allow a judgement creditor to step into the shoes of the member of an LLC or partner of a Limited Partnership.

Concept #5: *The Bridge Trust*®

The Bridge Trust® is a unique legal tool called an Asset Protection Trust (APT). Asset protection trusts have proven to be incredibly powerful in deterring and even eliminating lawsuits. They do this by creating a limitation on access to trust assets and *prohibit creditors from reaching those assets*.

Asset Protection Trusts come in several flavors. The first, created in 1984, and still today the most powerful version is called a Foreign Asset Protection Trust (FAPT). A FAPT is settled under the laws of a foreign jurisdiction like The Cook Islands, Belize or Nevis and

has very strict limitation on creditor access and a statutory prohibition on the recognition of foreign judgements – which includes the U.S.
Because of this, the FAPT is considered the strongest of all the asset protection trusts. But this significant protection comes with considerably more cost, IRS compliance and a loss of control of trust assets to a foreign trustee. For this reason, FAPTs are typically reserved for high-risk or special circumstance clients.

A second option is a Domestic Asset Protection Trust (DAPT). These have the benefit of lower fees and less IRS compliance, and when the DAPT first arrived, many attorneys were hopeful that the DAPT would replace the FAPT.

Unfortunately, the DAPT has a fatal flaw. Unlike the FAPT, whose trustee is offshore and can disregard a U.S. court, the DAPT is still domestic and cannot just ignore another court in the U.S. Since 1998 when the DAPT first came on the scene, we have had many high-profile failures and today the DAPT is considered too uncertain a tool for most experienced attorneys to recommend, I certainly don't.

The Bridge Trust® was designed to take the best of both worlds. *The Bridge Trust®* is a hybrid of the FAPT and the DAPT. It is set up and registered in the foreign jurisdiction, but for purposes of the IRS, the trust is *bridged* back and considered a domestic trust for tax purposes.

The effect is that *The Bridge Trust®* is simple to use and maintain as a domestic trust, and the client can serve as the controlling trustee when waters are calm. If the weather gets rough and a true threat to the trust assets arises, *The Bridge Trust®* "crosses the bridge" and becomes a fully foreign FAPT. In this way *The Bridge Trust®* gives you the simplicity and reduced costs and compliance of a domestic trust and the protection of a Foreign Asset Protection Trust if ever needed. Truly the best of both worlds.

Concept #6: Full Step-by-Step Integration

Now that we have all the important concepts we need to protect your real estate let's put it all together.

Step One: Determine the NET VALUE of the real estate you own. (Let's use $1,500,000 for this example)

Step Two: Determine how much risk you are willing to group into a single risk pool (I recommend about $500,000 as a maximum for any single LLC. This segregates the property value and limits the inside liability risk)

Step Three: Divide your real estate into groups that total no more than your single risk pool maximum. (In our example, $1.5M would be 3 groups of properties worth $500K each)

Step Four: Create a separate LLC for each group of properties and transfer the properties into each LLC. (Here we would create 3 LLCs)

Step Five: Create your multi-member holding company in an appropriate State which will own the above LLCs. (Here we are going to create an Arizona Asset Management Limited Partnership)

Step Six: Transfer ownership of each LLC into the AMLP as the single member (This eliminates the need for the LLC's to file any tax returns and consolidates all accounting and filing on the AMLP books and return)

Step Seven: Add the final outer "waterproof" layer of asset protection by creating *The Bridge Trust®* and connecting it to the holding company as the majority limited partner.(This provides a true escape route for the value of all the properties held by the holding company.)

Step Eight: Integrate you new Asset Protection plan with your existing estate plan which will ensure your assets are passed to your children or heirs smoothly and with the minimum estate taxes.

The Takeaway

I have witnessed Asset Protection to be one of the most liberating steps my clients can take to increase confidence in their financial future.

For most of my clients, the flexibility of *The Bridge Trust®* combined with the holding company and the individual LLC's strikes the right balance between the mitigation of the risks, the costs, the control, the compliance and the ultimate effectiveness of the planning.

For more information on Asset Protection Planning using *The Bridge Trust®* visit www.lodmell.com or call 800-231-7112 or email info@lodmell.com to set up a consultation.

Frequently Asked Questions (FAQs)

In my experience virtually every case I have worked on by creating the 3-layer method outlined above this has been enough to fully protect all of my client's real estate. In 90% of those cases, we never had to cross the bridge of *The Bridge Trust*®. However, there are 3 questions I get most often which are worthy of addressing here.

Question #1:

Does the Bridge Trust still work with real estate since I cannot move the properties offshore as easily as I can move cash or securities?

This is really the critical point to understand. First of all, legal cases take years to unfold and develop. By creating your plan prior to any such threat arising, you are legally transferring the ownership of your properties to *The Bridge Trust*®.

As the case matures and it becomes apparent that the likelihood of a significant judgment is high, then the trustee of *The Bridge Trust*® can take whatever steps are necessary to protect the trust assets – which include the properties. The options at that point are to strip equity from the real estate, leaving very little value for a creditor (see concept #1). That liberated equity may now be placed directly in *The Bridge Trust*® in the hands of the foreign trustee in an offshore bank. This virtually destroys any incentive the creditor has to continue to pursue the property. Of course, the other option is to sell the real estate, similarly liberating the equity and doing the same thing.

If triggering *The Bridge Trust*® into a FAPT is the right strategic move to make, the inherent delays in the US legal system provide more than enough time. The idea that the average plaintiff can run into court and convince a judge to freeze all your assets before a trial is unfounded.

<u>I have never witnessed any case in which that has occurred or a request for such has even been made.</u> I advise clients that if this is a real risk, then they may be the rare case where beginning with a fully foreign APT should be considered.

Question #2:

Does waiting until after the threat has materialized to cross the bridge create a fraudulent conveyance?

A conveyance occurs with the change of ownership to the assets. When *The Bridge Trust*® crosses the bridge there is NOT a change in ownership, since *The Bridge Trust*® already owns the assets previously held in the U.S. Therefore, by definition, crossing the bridge does not qualify as a "conveyance" and hence would not be a fraudulent conveyance.

Perhaps the more important question is, "*What would happen if a court did determine that crossing the bridge was a fraudulent conveyance anyway?*"

Again, I would look at what the impact on the trust assets would be, and once *The Bridge Trust*® becomes a FAPT, any challenge to this would have to be heard in the High Court of the Cook Islands. Therefore, the effect would be that even in the case where a judge made such a determination, *The Bridge Trust*® would still be effective.

Question #3:

Could a court in the US invalidate the Trust?

The answer is yes. It is possible for a court in the U.S. to do almost anything you can imagine, including invalidate any trust. This includes a FAPT or a DAPT and yes *The Bridge Trust*®. There is simply no way to ensure what a U.S. court is going to do. This unpredictability of the U.S. legal system is the major reason why we use *The Bridge Trust*® in the first place.

The more important question is, *what would be the impact?*

If good strategy has triggered *The Bridge Trust*® into a FAPT, then a U.S. court invalidating it would make virtually no difference to the effectiveness of the trust. For all the same reasons that the fully foreign APT is going to withstand a U.S. court challenge, so will a triggered *Bridge Trust*®.

About the Author

Douglass S. Lodmell, J.D., LL.M., is the Managing Partner of Lodmell & Lodmell, P.C. and founder The Asset Protection Council. He has authored numerous articles for professional journals as well as a popular book about the explosion of lawsuits in America called ***The Lawsuit Lottery: The Hijacking of Justice in America.***

Mr. Lodmell's extensive experience in asset protection make him a frequent guest speaker at professional conferences and seminars, as well as teaching concepts of asset protection to other attorneys at continuing legal education seminars throughout the country.

A nationally recognized expert in the area of Asset Protection, Mr. Lodmell holds a Juris Doctorate from the Cardozo School of Law and an advanced law degree (LL.M.) in Taxation from NYU School of Law and is a member of both the Arizona and Florida Bar.

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