

## **Limited Liability Company – Questions and Answers**

### **Asset Protection Planning**

#### **Question 1: Should I consider using an LLC to protect my assets?**

Answer: Whether or not an LLC is right for you depends on what you own, how you own it, your willingness to part with control, and your level of risk. It is beneficial to hold investment assets within an LLC. I would not suggest putting personal use property into an LLC. For example, if you own rental real estate outside of an LLC, e.g. in your name alone, the property and your other assets are open to attack from two directions. First, if a person is injured on the property and the judgment exceeds insurance coverage limits, the plaintiff may seize the real property or your brokerage and bank accounts to satisfy the judgment. Second, if a plaintiff sues you for something totally unrelated to the property and wins, the plaintiff may seize the property to satisfy the judgment. If the property were held in an LLC, the plaintiffs in the two examples above would be limited to what they could seize. In the first example, the plaintiff would be limited to satisfying the judgment out of the value of the rental property; he could not seize your personal assets. In the second example, the plaintiff could not seize the rental property; his only remedy would be a charging order against distributions that the LLC makes to you. If the LLC makes no distributions, the plaintiff gets nothing. The plaintiff cannot seize your membership interest.

#### **Question 2: The LLC looks like a strong tool; are there risks?**

Answer: There are always risks. (1) If the plaintiff can prove that the injury was due to your personal negligence, rather than to the negligence of someone you hired, he might sue you directly and get at your personal assets if he wins. This is why it's usually better to hire a management company, employee, or independent contractor to work on investment property. (2) If you fail to respect the entity, a plaintiff might pierce the veil of protection and seize the asset held within an LLC. Some clients are just unable to see that they and the LLC are two different "persons" under the law. They use the LLC bank account as their own, they treat the property as their own, they fail to obey the terms of the operating agreement, and just generally ignore the LLC. In these cases, why should the plaintiff and judge respect the entity? (3) There is a Colorado Bankruptcy case that ignored a single-member LLC for asset-protection purposes. The judge opined that the statute was intended to protect innocent members from the consequences of a culpable member's acts; since there was only one member, the culpable one, the judge denied LLC protection. This is why you may want to consider giving an interest in the company to someone else.

#### **Question 3: To whom may I give LLC membership interests?**

Answer: You can transfer membership interests to almost anyone or any entity, including your spouse, children, trusts for children, siblings, trusts for charities, friends, other

LLCs, partnerships, and C Corporations. For example, let's assume that you want to transfer a brokerage account into an LLC. You create the LLC and change the ownership of the account. You then create trusts for your children and transfer LLC membership interests into the trusts. The trustee exercises the rights of ownership on behalf of the children. You may manage the company or hire an independent manager. The income and dividends may be reinvested or distributed to you and the trusts for your children. The percentage of income and dividends that the trusts receive depends on the percentage of membership interest you transferred to them.

**Question 4: What is a charging order?**

Answer: The only remedy a creditor has against a debtor/LLC member is to obtain a charging order entitling the creditor to the debtor's share of any actual current or liquidating distributions. The right to a charging order replaces any other method of attachment or garnishment otherwise available to the creditor with respect to the debtor/LLC member. Some courts have held that a *partnership* interest can be sold to satisfy the claims of a creditor when the charging order fails to do so, but the New Jersey LLC statute declares the charging order as the sole remedy.

**Question 5: I know that I can form an LLC online by myself. Why do I need a professional advisor such as an attorney?**

Answer: True, you can form the company online, but the mere existence of the LLC offers little protection. A professional can draft the Operating Agreement to include the provisions you want and need and can monitor activities that may cancel statutory protection. You need good documents and procedures to benefit from the statutory protection. Further, you may get significantly more protection from an LLC formed in a different state or country. An advisor familiar with the options can help you make the right decision.

**Question 6: What is the difference between an LLC and a corporation?**

Answer: The sole remedy of a creditor of a debtor/LLC member is the charging order against distributions. The creditor of a debtor/corporation shareholder may attach and gain ownership of the shares, thus giving the creditor significant management rights. For asset-protection purposes, the LLC is a better structure.

**Question 7: Where should I form my LLC?**

Answer: The jurisdiction of formation depends on a number of variables that include the nature of the asset, your goals, your comfort level, the laws of the various jurisdictions. With the Colorado bankruptcy court case that pierced a single-member LLC, a foreign LLC might be better than a domestic. If you are going to fund the LLC with real property, a local LLC might offer the same benefits as a foreign LLC. If the state where

you live permits a creditor to attach your membership interest, you should consider forming the company in another state or country.

**Question 8: May I put my personal residence in an LLC?**

Answer: You may, but it might not be a good idea. First, you will lose capital-gains tax benefits. Second, if you fail to pay fair-market rent you will probably lose any protection. Third, a judge might look unfavorably on someone who has transferred all assets, including a personal residence, into protected entities, find that you made fraudulent transfers, and disregard the entity.

**Question 9: May I use an LLC as a 3<sup>rd</sup>-party, asset-protection device?**

Answer: Yes. One situation where the LLC might be helpful is when a child for whom you have funded a custodial account is reaching the age of majority (18 or 21). You can invest the custodial account funds in a family LLC into which you also have contributed funds. Your child will be a member; you will be a managing member with decisions over distributions. Thus, your child will not get control over the money at 18 or 21.

**Question 10: Will I become personally liable for the liabilities of the LLC?**

Answer: No member of an LLC is personally obligated for any debt, obligation or liability of the company, or for any debt, obligation or liability of any other member of the company, by reason of being a member of the LLC. However, if you personally assume liability or guarantee a debt, you will be personally liable. If possible, always sign as member or manager, and clearly acknowledge the entity on all correspondence.

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## **Limited Liability Company – Questions and Answers**

### **Tax Planning**

#### **Question 1: If I transfer an asset into a single-member LLC, will I have to pay any tax?**

Answer: No. The transfer is to yourself for income tax purposes, thus there is no capital gains on the transfer.

#### **Question 2: If I give membership interests to my children, will I have to pay gift tax?**

Answer: Whether or not you pay gift tax and how much you might pay depends on the value of the membership interests you transfer. The IRS taxes the transfer of property by gift, whether direct or indirect. Any transaction in which a property interest is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax. You are permitted to transfer up to \$12,000.00 per year per person. On top of this, you have a \$1,000,000.00 lifetime exemption that you may use by filing a Form 709 gift-tax return. The fair market value of the membership interest transferred may be less than the fair market value of the same percentage of property ownership outside the LLC. With the LLC you may leverage your gift-tax exemptions. This may also work in situations where you expect the underlying asset to appreciate considerably over time.

#### **Question 3: If I transfer an asset to an LLC and then transfer membership interests to my children, what percentage of the value of the property will be included in my taxable estate?**

**Answer: The answer depends on whether or not you relinquished sufficient control over the asset to remove the value of the asset from your estate. The IRS** imposes a federal tax on the taxable estate of every decedent who is a citizen or resident of the United States. A “taxable estate” is defined as the value of the gross estate less applicable deductions. The value of the “gross estate” includes the value of all property to the extent of the interest therein of the decedent at the time of his death. In addition, any property that the decedent transferred during his life is returned to the gross estate if the decedent retained the enjoyment, possession or right to income during his lifetime. For example, if you transfer a membership interest in an LLC to your child for free, but retain the right to 100% of the LLC income, i.e. ignore your child’s right to his pro rata share of income, the full value of the property will be included in your estate. You should respect the terms of the operating agreement and *not* try to avoid the economic substance of the transaction through some express or implied agreement to the contrary.

**Question 4: Upon what will the IRS base its decision whether or not to bring the asset back into my estate?**

The IRS will first look at the documents to see if they meet the requirements of the Tax Code. If so, then they will try to discover evidence to prove that you did not act according to the legal terms of the operating agreement. There are several tax doctrines that the IRS may rely on: (1) step transaction; (2) substance over form; (3) business purpose (more than just tax avoidance); (4) sham transaction; and (5) economic substance. It is always a good idea to have a purpose for the LLC other than just tax reduction or avoidance. These purposes may include asset-protection, ease of management, access to markets, etc.

**Question 5: How is an LLC taxed?**

Answer: A multi-member LLC is taxed as a partnership and a single-member LLC is taxed as an individual, i.e. all items of income and loss are reported by the members. The LLC is a flow-entity. Each member is responsible for his pro rata share of income taxes. Each member must report his share of company profits, whether distributed or not, on his individual return. Generally, the character of items for tax purposes is determined at the company level and they retain that character in when they flow through to the member. If capital is not an income-producing factor, the transfer of a membership interest to a family member may be disregarded as an ineffective assignment of income. Where an interest is acquired by gift (an interest purchased by one family member from another is considered to have been acquired by gift), allocation of income among the partners according to the partnership agreement will not control to the extent that: (1) it does not allow a reasonable salary for the donor of the interest; or (2) the income attributable to the capital share of the person receiving the interest is proportionately greater than the income attributable to the donor's capital share. The transfer must be complete and the family member receiving the interest must have control over the membership interest consistent with the status of member. If he is not old enough to serve in the capacity of member, his interest must be controlled by a fiduciary for his benefit.

**Question 6: I don't want to give up the use, enjoyment, control of and income from my property. Can I still use an LLC?**

Answer: You can still use the LLC, and it still may offer significant asset-protection and other economic benefits, but it will not be an effective tool to reduce estate taxes. It all depends on what you want to and need to accomplish. Rejecting an LLC on the grounds that it does not reduce taxes even if it can benefit you and your family in some other way, is short sighted.

**Question 7: Does the jurisdiction of where I form my LLC affect my tax liability?**

Answer: The state of formation may impose certain taxes and fees, so you should consult an accountant in that jurisdiction. The federal rules govern throughout the United States, so they will not change regardless of where you form the company.

**Question 8: Does forming an LLC in a foreign country offer any tax benefit?**

Answer: Generally speaking, no. There is no additional tax benefit to forming an LLC in a foreign country. A multi-member LLC will be taxed as either a foreign corporation or a partnership, and a single-member LLC will be disregarded. The foreign LLC may, however, provide additional asset-protection benefits. The filing requirements are comparable to those required of grantors of international trusts. Citizens of the United States are taxed on income derived from all sources, both domestic and international. There may be tax benefits for entities conducting business internationally.

**Question 9: I've heard of cases where a United States citizen can enjoy tax-free income by opening a foreign corporation or LLC and "hiding" the income. What do you think?**

Answer: It's illegal to "hide" income. Consider legal ways to avoid taxes and keep you out of jail.

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