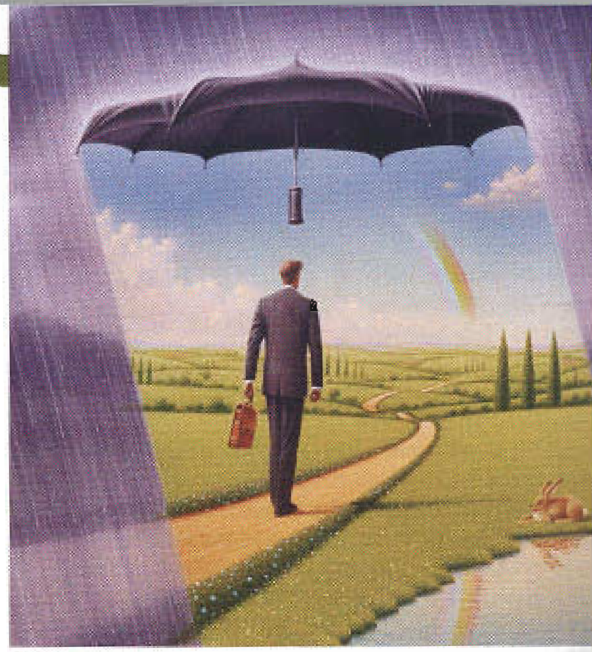

Planning With LLCs

LLCs Offer Asset Protection, Business Flexibility, and Tax Advantages

BY JACOB STEIN, ESQ.

From the time limited liability companies came into prominence, practitioners have been working to maximize their asset protection, business flexibility and tax advantages, among other benefits.

CHARGING-ORDER PROTECTION

Liability protection is a main reason for forming an LLC. The LLC protects the members from lawsuits directed against the entity [California Corp. Code Sec. 17101(a)] and protects the assets within the LLC from lawsuits against the members. This is often called an outside-in versus inside-out asset protection.

Protection of the entity's assets from lawsuits against the members, afforded by the so-called charging-order, is an advantage LLCs have over corporations [California Corp. Code Sec. 17302(a)]. Corporations offer liability protection only if the lawsuit is directed against the entity, not if it's directed against the shareholder.

The charging order limits the creditor to an economic interest in the LLC without transferring the membership interest or any control over the entity to the creditor. As a result, the creditor often receives phantom income—no cash is distributed to the creditor, but income is allocated to the creditor for tax purposes.

Though California statutes extend charging-order protection to all LLCs, whether multi-member (more than one person or entity holds a membership interest) or single-member [California Corp. Code Sec. 17302(a)], be aware that one court has found that charging orders do not apply to single-member LLCs [In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003)].

Clients with single-member LLCs that want to maximize the protection of the entity's assets from lawsuits against the sole member should consider adding members. The new members must have a capital interest in the LLC, but not necessarily a profit interest [California Corp. Code Secs. 17001(x) and (z)].

For LLCs set up by family members, a so-called poison pill provision should be considered. This provision usually allows either the LLC or other members to buy out the debtor-member for a nominal amount.

The poison pill has the effect of substituting the debtor-member's membership interest with a nominal amount of cash, which limits the assets a creditor can collect against. In some cases the provision eliminates the need for charging-order protection, which is particularly effective when the LLC is holding depreciable real estate and is passing through losses.

The charging-order protection is critical for businesses with valuable assets, such as real estate, significant accounts receivable, contracts or intellectual property. Service businesses, such as consulting firms, generally have no assets to protect, and the charging-order protection is less critical.

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DELAWARE SERIES LLCs

Like corporations, LLCs generally protect owners from lawsuits directed against the entity. But the assets within the entity are not protected from such lawsuits and the creditor of the LLC may be able to reach the entity's assets.

Accordingly, rather than place all assets in one LLC, practitioners usually advise clients to form multiple LLCs, placing a single asset in each LLC.

This structure works well for a client who owns a couple pieces of real estate or other business assets, for example. But for a client with many assets, the fees and costs of setting up dozens of entities add up quickly. In these cases, Delaware Series LLCs are a creative solution.

Under Delaware law, a single LLC can have assets placed within separate series (akin to compartments) and an asset placed in one series is protected against the liabilities arising in a different series, provided separate books and records are kept for each series. [Sec. 18-215, Delaware Limited Liability Company Act].

In addition to the liability limitation, Series LLCs offer the added flexibility of having different managers and members in each series. For federal and California tax purposes, practitioners can choose whether to file one tax return for all series or a separate return for each. In practice, a single return is filed and each series is tracked solely from a bookkeeping standpoint.

The frequent question from clients and practitioners is: Does California recognize Series LLCs? The short answer is yes.

Under California Corp. Code Sec. 17450(a), a foreign LLC that registers to do business in California will continue to be governed by the laws of the foreign jurisdiction where it is organized. Foreign refers to any jurisdiction other than California, including other states.

This would indicate that Delaware law applies to a Series LLC registered in California.

The benefits of a Delaware Series LLC can be seen in the following example.

A client with 40 parcels of real estate in California, each owned through a separate LLC, would have to pay $32,000 a year in California minimum franchise taxes, significant legal fees varying and tax return preparation fees for 40 partnership returns.

Using a Series LLC, that same client can reduce its California franchise tax to $800.

LLCs have quickly become the default entity of choice for tax planning, estate planning and asset protection.

Although the client's LLC has 40 series, with each holding a separate real property parcel (and each separate from the rest for liability purposes), only one LLC is registered in California. Further, only one LLC agreement needs to be drafted and only one return needs to be filed.

Because all 40 properties are aggregated on one tax return, the LLC may become subject to the California gross receipts tax imposed on LLCs. To avoid that, a Delaware Series limited partnership may be used instead of a Series LLC. If the client has multiple LLCs, each paying the maximum gross receipts tax, converting the existing LLCs to one Series LLC will result in one gross receipts tax.

Each parcel of real property is then titled into a specific series of the LLC. Each series would have separate books and bank accounts.

PROTECTION OF BUSINESS ASSETS

If a business is exposed to risks and liabilities, so are its assets. For example, Tireco Inc. owns a patent to, and manufactures and sells, the world's most amazing automobile tire. If one of its tires ever disintegrates, the lawsuit will be directed against the company, as it is the manufacturer and seller.

If the lawsuit is successful and exceeds the insurance coverage, it would reach Tireco's assets—including the valuable patent—and possibly place Tireco in bankruptcy.

The solution is to manufacture and sell the tires and form another LLC, owned by Tireco's shareholders, to own the patent, with a non-assignable licensing agreement between the two entities. This way, the creditor can't reach the patent if there is a lawsuit against Tireco.

One can see how each significant asset of a business can be insulated using a Series LLC, with a separate licensing agreement (if appropriate) running from each series to the operating entity.

PICKING THE BEST JURISDICTION

For tax minimization, if the LLC is taxed as a partnership, where it is formed is irrelevant to a member residing in California, which taxes any resident member on its allocable income.

If the LLC is taxed as a corporation, Nevada may be a good choice, but only if the business is located there or has no easily ascertainable physical location, such as an internet-based business. Keep in mind that a Nevada corporation doing business in California will always be subject to California taxes.

From a tax-planning standpoint, many foreign jurisdictions (such as the Caymans or Nevis) should be considered for LLCs taxed as corporations.

There are many reasons for picking one jurisdiction over another. For example, California does not allow anyone licensed under the Business and Professions Code to practice their profession through an LLC, while some other states allow that.

TAX PLANNING

LLCs may be taxed as corporations, partnerships or disregarded for tax purposes. In practice, single-member LLCs usually are disregarded, whereas multi-member LLCs generally are treated as tax partnerships.

Since LLCs are usually tax partnerships, contributions and distributions are generally tax-free and the partnership tax planning opportunities abound. LLCs can be used to structure leveraged partnerships and tracking allocation transactions, generate multiple losses and strip basis on distributions and redemptions.

LLCs also make it easier to allocate non-recourse loans to all members and plan for deficit capital account exit strategies.

In short, LLCs taxed as partnerships offer all the tax advantages of limited partnerships, no general partner exposure and none of the corporate tax disadvantages.

In California, spouses who own LLC interests as community property and are the only members, can choose whether the LLC will be treated as a partnership or a disregarded entity for income tax purposes (Rev. Proc. 2002-69). This makes it easier for spouses who own real estate through a disregarded LLC to complete Sec. 1031 exchanges, as there is no risk that the real estate interests will be reclassified as partnership interests

Some clients have existing businesses that are organized as corporations and are looking for the charging-order protection of the LLC. If the corporate exit tax is too high the corporation may be kept in place and an LLC (preferably multi-member) substituted as the sole corporate shareholder. While tax problems remain, the client has charging-order protection.

If the corporation has made an S election, then the top-tier LLC should be a disregarded entity, which means it either has only one member or a husband and wife are holding membership interests as community property. Either structure minimizes the charging-order protection effectiveness.

In that case, an LLC formed in a foreign jurisdiction and elected to be treated as a disregarded entity, would offer the client tax neutrality and a better degree of asset protection. It is likely that some foreign jurisdictions would offer more charging order-protection to single-member LLCs than domestic states.

An alternate solution is to form a new LLC, elect to tax it as a corporation (even making an S election if necessary) and merge the existing corporation into the LLC. From a tax standpoint, the transaction is treated as a tax-free reorganization, and from a liability standpoint, assets are now owned by an LLC providing charging-order protection.

There are circumstances when corporations are the right entity for tax reasons. If that's the case, and the charging-order protection is still desired, the solution would be similar to the one above—form an LLC and elect to tax it as a corporation. This results in corporate tax treatment for federal and California tax purposes, and LLC treatment for asset protection purposes.

These are just some of the benefits of LLCs, which have quickly become the default entity of choice of practitioners for everything from tax planning to estate planning to asset protection.

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