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CaseStudy

Asset Protection Planning with Limited Liability Companies

This case study has been adapted from *PPC's Guide to Limited Liability Companies*, 13th Edition, by Michael E. Mares, Sara S. McMurrian, Stephen E. Pascarella II, Gregory A. Porcaro, Virginia R. Bergman, William R. Bischoff, and Linda A. Markwood, published by Thomson Tax & Accounting, Ft. Worth, TX, 2007 ((800) 323-8724; ppc.thomson.com).

When consulting with a client regarding forming a limited liability company (LLC) for business and tax reasons, it is common to address the issue of asset protection. The basic objective of asset protection engagements is to transfer assets to reduce or eliminate any exposure to liabilities in conjunction with the client's estate plan or other financial concerns. Care must be taken to avoid transfers specifically to avoid creditors, which can be considered fraudulent.

Practitioners often are in an excellent position to identify the need for an asset protection strategy and recommend possible methods of implementation. For example, suggesting the formation of an LLC before a client acquires a parcel of commercial real estate may protect the client from liability exposure. The practitioner may also suggest that the client restructure his or her existing holdings to protect assets.

Caution: Restructuring a client's existing asset holdings for asset protection purposes has many legal implications that must be considered with the assistance of an experienced attorney.

In general, a transfer of assets to an LLC protects the assets from the LLC member's creditors. However, a member's creditors can obtain a charging order against the member's interest and become entitled to receive any profits, losses, and distributions to which the member would otherwise be entitled. The creditor does not, however, have the right to participate in LLC management, including the right to force a distribution. This may put the creditor in a difficult position, since he or she may be allocated the debtor member's share of LLC taxable income but receive no distribution to pay the income taxes due on that income.

Fraudulent Transfers

Any asset protection plan must consider the possible application of fraudulent transfer laws. The purpose of these laws is to prevent debtors from transferring assets for the primary purpose of defrauding creditors. If a court determines an asset transfer to be fraudulent, the transfer will be voided, exposing the asset to a creditor's claim.

Fraudulent transfer laws vary from state to state and are also addressed in the U.S. Bankruptcy Code and the Internal Revenue Code. Three common questions considered by most jurisdictions when applying fraudulent transfer laws are:

1. Did the transferor intend to hinder, delay, or defraud a creditor at the time the transfer was made?
2. Was the transferor solvent at the time of the transfer?
3. Was the transfer made in exchange for reasonably equivalent consideration?

While formulating asset protection plans that involve the transfer of assets, practitioners must objectively consider a possible challenge from the point of view of the client's creditors. The business purpose for the transfer should be documented in order to prove that the transferor did not intend (actually or constructively) to defraud a creditor.

The evaluation of the transferor's intent is based on the facts and circumstances at the time of the transfer. Though fraudulent transfer laws vary from one jurisdiction to another, indications of fraudulent intent (commonly called badges of fraud) include:

1. Retaining control or possession of the transferred property;
2. Concealing the transfer;
3. Transferring assets after litigation began or under the threat of litigation;
4. Transferring substantially all the client's assets;
5. Receiving inadequate consideration from the transferee; and
6. Transferring assets in an amount that results in the transferor's insolvency at the time of the transfer or shortly thereafter.

Practitioners should prepare a detailed solvency analysis at the outset of an asset protection engagement to document their client's financial position prior to any asset transfer. This is an important step because the transferor's insolvency at the time of an asset transfer (or shortly thereafter) is an important indication of fraudulent intent. The Uniform Fraudulent Transfer Act (UFTA) and the Uniform Fraudulent Conveyance Act (UFCA) provide similar definitions of insolvency. Both acts consider transferors insolvent if their debts exceed the fair market value of their assets and exclude any assets that are exempt from creditor claims when determining solvency. Under the UFTA, a debtor is presumed to be insolvent if he or she cannot pay debts as they become due.

Both acts take into account contingent liabilities; however, the UFCA considers them at face value. Under the UFTA, contingent liabilities are considered at the amount they are most likely to be settled for. The UFTA provision generally benefits debtors. However, due to a lack of guidance, care must be taken to document the calculation of the discounted liabilities.

Caution: A practitioner who recommends a fraudulent transfer may be subject to legal sanctions and/or may be in violation of professional ethics. Practitioners should not engage in formulating asset protection plans unless they have sufficient knowledge of the underlying law. In addition, an attorney with experience in this area should be consulted.

Principal Residence Protection

From an asset protection standpoint, the use of an LLC to hold a personal residence may provide liability protection that is superior to the typical tenant by the entirety title generally used by married individuals to own a personal residence. A single person would clearly have additional protection when compared to individual ownership.

Basic estate planning for married individuals generally requires the segregation of assets in order to maximize the use of each person's unified credit amount. The use of an LLC makes it easier to fragment ownership of a personal residence without increasing exposure to possible liabilities.

While it appears that the use of an LLC to hold a personal residence may offer a variety of advantages to the property owner or owners, it is important to note that the IRS has taken a position that the period of time a personal residence is held by a partnership (including an LLC) will not qualify as a personal period of ownership under the gain exclusion rules of Sec. 121 (Letter Ruling 200119014, revoking Letter Ruling 200004022). Accordingly, practitioners should analyze the owners' tax positions carefully before putting a personal residence into a multimember LLC.

Alaska and Delaware Trusts

Alaska and Delaware provide a domestic alternative to offshore asset protection. (Many other states have similar provisions.) The Alaska asset protection trust can provide distributions to the grantor (as a beneficiary) at the discretion of the trustee without exposing the trust to claims of the grantor's creditors. The Delaware law extends spendthrift protection to an irrevocable trust of which the grantor remains a discretionary beneficiary, as long as the trustee is neither the grantor nor a related or subordinate party.

The Alaska Trust Act does not prevent a creditor from voiding a transfer to an asset protection trust on grounds of fraud. However, it does provide substantial protection from the claims of certain of the grantor's creditors. This level of protection for self-settled trusts is rare in the United States. (In addition to providing asset protection, the Alaska statute enables individuals to make completed gifts for estate tax purposes while remaining an eligible beneficiary of the trust.)

Enforcement Issues Involving Alaska and Delaware Trusts

While Alaska and Delaware trusts provide better protection than trusts governed by the laws of other states without similar provisions, several significant enforcement issues may arise.

Generally, the Full Faith and Credit Clause of the U.S. Constitution requires state courts to recognize judgments of courts in other states. Accordingly, a plaintiff seeking to set aside a transfer to an Alaska trust may be able to sue in a creditor-friendly state. Once a judgment is obtained, it can be brought before an Alaska court for enforcement purposes only; the merits of the case would not be retried.

Observation: Generally, the law governing the trust (i.e., Alaska law in the case of an Alaska trust) is applied in litigation involving the trust, even if the dispute is being tried in another state. Accordingly, advocates of using such trusts argue that state laws will protect trust assets even if disputes are being tried in other states. However, there are exceptions to the general rule that a court must apply the law governing the trust. One such exception occurs when the law governing the trust violates the public policy of the state in which the litigation is taking place. Most states have laws expressly invalidating self-settled spendthrift trust provisions. In many states, it seems that courts would have little problem ignoring the Alaska and Delaware-type self-settled spendthrift trust laws as contrary to public policy.

Alaska and Delaware trusts also must contend with constitutional issues arising under the Supremacy Clause, which generally provides that state statutes that contradict a federal law are not valid. For example, a (federal) bankruptcy court will likely try to attach assets held in one of these types of trusts. In addition, other state laws (such as the Uniform Enforcement of Foreign Judgments Act) may contradict the trust statutes, raising questions about whether the trust statutes will be enforced.

Delaware Series Partnerships and LLCs

Delaware and many other states allow for the creation of "series limited partnerships" (SLP). These rules also apply to LLCs classified as partnerships. This type of partnership or LLC can designate separate series (or divisions) within the entity into which assets and ownership interests can be segregated (Del. Code §§17-218(a), 18-215(a)). The SLP can be structured to take advantage of the segregation possibilities under the statute—allowing each series to stand alone as a separate entity. Each series within the series partnership or LLC can have its own business or investment purpose, classes of ownership interest, and liability limitations.

Originally, these provisions were intended to allow the creation of multiple hedge funds or similar investment fund series within a single state law entity. However, SLPs may be used for any type of business—real estate interests, operating business, or any other assets. Although an SLP is considered a single legal entity for state purposes, the federal income tax treatment is a gray area.

In its first ruling on the treatment of series LLCs (Letter Ruling 200803004), the IRS indicated that a separate series in an LLC with more than one owner will be treated as a separate partnership if the election to be classified as a corporation is not made. A separate series with one owner is taxed as a disregarded entity.

It is important to note that the ruling in this case was based on a structure with the following proposed operation:

1. Each LLC series will consist of a separate pool of assets, liabilities, and stream of earnings.
2. The shareholders of an LLC series may share in the income only of that LLC series.
3. The ownership interest of the shareholders of an LLC series will be limited to the assets of that LLC series upon redemption, liquidation, or termination of that LLC series.
4. The payment of the expenses, charges, and liabilities of an LLC series will be limited to that LLC series' assets.
5. The creditors of an LLC series are limited to the assets of that LLC series for recovery of expenses, charges, and liabilities.
6. Each LLC series will have its own investment objectives, policies, and restrictions.
7. Votes of shareholders may be conducted by each LLC series separately with respect to matters that affect only that particular LLC series.
8. The shares of each LLC series are not, and will not be, traded on an established securities market or regularly quoted by any person, such as a broker or dealer, making a market in the shares.
9. No person regularly makes available, and will not make available, to the public (including customers or subscribers) bid or offer quotes with respect to the shares or stands ready, or will stand ready, to effect buy or sell transactions at the quoted prices for itself or on behalf of others.
10. No shareholder has, or will have, a readily available, regular, and ongoing opportunity to sell or exchange the shares through a public means of obtaining or providing information of offers to buy, sell, or exchange shares.

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EditorNotes

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Clarification

The September Case Study, "Benefiting from a Fiscal Tax Year," should have noted that it was adapted from *PPC's Tax Planning Guide—Closely Held Corporations*, 21st Edition, by Albert L. Grasso, Joan Wilson Gray, R. Barry Johnson, Lewis A. Siegel, Richard L. Burris, Mary C. Danylak, Timothy Fontenot, James A. Keller, and Michael E. Mares, published by Thomson Tax & Accounting, Ft. Worth, TX, 2008 ((800) 323-8724; ppc.thomson.com).