

LIMITED LIABILITY COMPANY

(Asset protection)

HIGHLIGHTS OF THE PLAN

IN GENERAL

A Limited Liability Company (LLC) is a flexible business and investment entity that provides protection from the claims of creditors for assets that are placed in the LLC. If structured properly, an LLC provides a single layer of pass-through taxation, just as a partnership. However, an LLC differs from a partnership in that all Members, as they are called, including managing Members, are at risk for only their investment in the LLC. In a partnership, even a limited partnership, the general partners can incur liability in excess of their contributions to the partnership. Unlike a limited partnership where limited partners are restricted from participating in managing the affairs of the business, any Member in an LLC may be a managing Member.

An LLC differs from an S corporation in that it can have more than 75 Members, have more than one class of company interests, have interests owned by entities other than natural persons or trusts that represent natural persons, give Members disproportionate distributions, enable a Member's adjusted basis in the company to be increased by nonrecourse debt, make special allocations of profits and losses among Members, and be subject to termination upon the withdrawal or removal of any Member.

HOW THE LIMITED LIABILITY COMPANY IS STRUCTURED

Although some states permit an LLC with just one Member, most require at least two. Unless an LLC is managed by all Members, jointly and severally, it must have one or more managing Members. Limited liability companies may be capital-based or service-based. That means that income produced by the LLC may come either from capital investments or personal services of the managing Members.

Managing Members manage and control the LLC. Members who are not managing Members are not involved in the day to day operations of the LLC. In the absence of fraud or other malfeasance, neither Members nor managing Members can have personal liability beyond their investment in the LLC.

ASSET PROTECTION

The LLC affords some degree of protection from creditors. Suppose, for example, that a Member is sued by a creditor on a matter unrelated to the LLC. Further suppose that there are assets in the LLC worth \$1,000,000, and the creditor obtains a \$200,000 judgment against

Member A, who is a managing Member.

In most states, the most the creditor can do is obtain a charging order against Member A's interests in the LLC. This means that the creditor can assume Member A's right to receive distributions from the LLC. However, if, according to the terms of the LLC agreement, no distributions are made, the creditor must recognize the income that Member A would have otherwise had to have recognized but not receive any distributions from the LLC. Obviously, this is a very unfavorable position for the creditor to be in, having to recognize income without actually receiving any distributions from the LLC. Even if under state law a creditor could eventually reach the underlying assets of the LLC, the extra steps required to do so might make the creditor think twice before making the attempt.

ADVANTAGES OF A LIMITED LIABILITY COMPANY

It is taxed as a partnership, with all income and deductions passing directly through to the Members.

All Members, including the managing Members, are given limited liability.

Any Member can be a managing Member.

There is no double taxation as there would be with a corporation.

Special allocations of profit and loss can be made among the Members.

Members may receive disproportionate distributions.

A Member's nonrecourse debt at the entity level can increase the Member's adjusted basis in the company.

There is no recognition of gain on the part of the LLC for distributions of appreciated property.

There is transfer tax leverage due to discount gifting.

Since title to property transferred to the LLC vests in the LLC, creditors cannot reach the underlying assets. In the absence of fraud, the burden of proving which is on the creditor, transfers made for legitimate purposes will be beyond the reach of creditors.

The creditor can only obtain a charging order that permits taxable income to flow through without any actual distributions. The creditor cannot become a substitute Member.

If the LLC elects partnership status for tax purposes and if life insurance on the life of a Member is owned by the LLC, only that portion of the proceeds equal to the insured's pro rata interest in

the LLC will be includible in the insured's estate for estate tax purposes.