SPECIAL REPORT #6

Asset Protection Planning And Discounting With LLC's

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Trusts, Estates, and Taxes...
A Problem Solving Law Firm

The Limited Liability Company (LLC) affords a number of significant advantages in today's estate tax, estate planning, and asset protection environment. The typical LLC involves an entity organized pursuant to an Operating Agreement following state law. It has members consisting usually of trusts and/or individuals, one or more of whom are named in the Operating Agreement as the "managing member". In its purest sense, the family LLC would be formed by you and your spouse (or your trusts) and your children. One of the spouses would act as the managing member.

Comparing The LLC To The FLP

Similar to a Family Limited Partnership (FLP), the LLC is a transparent or "pass-through" entity for income tax purposes, and LLC's are not themselves subject to income tax. Like the FLP, income earned by the LLC is charged to you as members in proportion to the interest that each of you holds. When a member passes away, in many cases, the LLC may be able to obtain a step-up in basis of the underlying LLC asset by making the appropriate election. The LLC has some significant advantages over the FLP. The FLP is required to have at least one general partner. That general partner is subject to liability for any claim made against the FLP, although the limited partners escape that potential liability. This places the general partner's personal assets at risk. To avoid this problem, it is necessary to create another entity to act as the general partner. This general partner is nearly always a corporation that has little or no assets. This creates another entity, annual reports, additional fees, and an additional tax return each year. The LLC is only required to have a managing member, ***who bears no liability for the debts of the LLC or any claims that may be filed against it.*** This means that your assets, as the managing member, are not at risk as a result of your manager position.

The Series LLC

Another advantage of the LLC over the FLP, is that under a recent change in Illinois law, the LLC can now be created as a "Series" LLC. This means that ***those who hold multiple parcels of real estate, each of which could generate its own potential claims or liability, can now hold those parcels in a separate sub-LLC within the main LLC.*** The Operating Agreement need not change and the LLC still needs to file only one tax return no matter how many different series it may decide to create. You need only file a basic document with the Secretary of State. There is a State filing fee of $500 ($750 for Series LLC) and a $50 fee per series with an annual state fee of $250. If you were using the FLP structure, to provide the most insulation from claims made against any parcel of real estate, you would need to create a separate FLP for each parcel and pay an annual state fee for each FLP. That could be a paperwork nightmare and can create many separate tax returns. The Series LLC avoids that difficulty. Each time you acquire a new parcel of real estate, you simply create a new series (call them I, II, III, IV, etc.)

Creditor Protection Afforded By The LLC

Additionally, the LLC is an effective asset protection vehicle because ***your creditors can never become a member of the LLC (or any of its series).*** If a creditor did sue the LLC and won, they would only walk away with something called a "charging order." ***They still cannot use the LLC assets, make any decisions related to those assets, or force you to sell them.*** This is due to the restrictive language of the "Operating Agreement." The charging order would entitle them to a proportionate share of income or principal, ***should you decide to make any distributions,*** (which you wouldn't). We have found that most creditors or suing parties ***don't like charging orders***, because it gives them nothing but a potential tax liability for "phantom income". As far as the IRS is concerned, the party holding the charging order is liable for its proportionate share of the income earned by the LLC assets ***even though it never received any income distribution!*** You can transfer any of your brokerage accounts, rental or commercial real estate, stocks, mutual funds, etc into your LLC. The only real estate you can't transfer into your LLC, is your personal residence.

Estate and Gift Valuation Discounts Can Greatly Reduce Transfer Taxes

Planning with an LLC allows you to ***consolidate management of the multiple investment assets and business assets*** (real property and personal property) into a single entity. The LLC can provide the assets owned by it with ***"lack of control discounts"*** and ***"marketability discounts"*** (substantially reducing the taxable value of your investment real estate and investment portfolio and any future business holdings) for purposes of making lifetime gifts to your children and grandchildren. These same discounts can be achieved at the last spouse's death, thereby ***reducing Federal and state death tax***. The LLC form of ownership allows you to make gifts of "interests" in the LLC each year to your children/grandchildren at a substantial discount off of actual value. This can ***greatly reduce or even avoid gift tax issues.***

Restrictions must be incorporated into the Operating Agreement to limit a member's ability to sell his or her interest or to withdraw from the LLC and take his or her capital contributions out. Liquidation of the LLC would also be restricted to a unanimous vote of all members. Dissolution of the LLC would not occur upon the death of a manager or member. Other restrictions can be included as long as they are permitted under state law.

Extra Tax Benefits

It will also permit you to ***"freeze" the growth of the gifted membership interests*** in the LLC by having that growth inure to your children's shares of the LLC and not to yours, ***reducing the size of your taxable estate.*** Presently, the IRS has been conceding substantial discounts to a decedent's estate on the value of assets that have been held by a properly structured LLC. An initial operating agreement would be created by you and your trust, and after certain LLC interests have been "assigned"or transferred to your children as gifts, an amended operating agreement would be prepared which would include them as members. ***Adding your favorite charitable organization*** as a one percent (1%) member may even increase the "lack of control" discount which the IRS would be willing to concede.

For those of you with ***out-of-state real estate which may be subject to higher death taxes than Illinois*** (in states like Minnesota, Indiana, and others), the LLC allows you to convert your interest in the foreign real estate from that of "real property" to "personal property". The foreign state would effectively lose death tax "jurisdiction" over that asset because personal property must be taxed in the state of the decedent's residence unlike real estate, which must taxed by the state in which it is located.)

You Maintain Control

The family member who is acting as the ***managing member (you or your spouse), maintains long term control over the underlying assets.*** The managing member will also control the younger generation's use of their membership interests. The Operating Agreement can provide that the children do not have unrestricted use over their membership interests. Often, a children's trust or grandchildren's trust is created for the sole purpose of holding the younger generation's membership interests. ***The Operating Agreement is also very flexible, and based upon the terms of the Agreement can be easily amended.*** Investment standards are also much more liberal than are those of trusts, where all investments must be "prudent". The LLC is able to invest assets under the much broader "business judgment rule". This eliminates potential complaints from beneficiaries that may disagree with the investment choices made by the Trustee of a Trust.

In summary, an LLC as an estate planning and asset protection device, can be used effectively with real estate, closely held non-professional corporations, and marketable securities. Often your trust can participate as an LLC member and most likely should. Call us at 847-670-8200 if you would like to discuss this type of planning with us.