Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #83

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From: Steve Leimberg's Asset Protection Planning Newsletter
Subject: 8 Common LLC Planning Errors

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Alan warns LISI members of 8 common asset protection planning mistakes made when setting up and running LLCs.

EXECUTIVE SUMMARY:

Limited liability companies are quite often the entity of choice for investment and business holdings.

Problems can arise, however, where structuring does not take important risks and federal and state law requirements into account.

FACTS:

Some of the most common problems we encounter in reviewing LLC arrangements for clients are:

1. **TENANCY BY THE ENTIRETIES" DESIGNATION THAT WILL NOT QUALIFY AS TENANCY BY THE ENTIRETIES.**

   Many married couples in states that protect tenancy by the entireties assets from the creditors of one spouse or the other have their LLC interests titled jointly as tenants by the entireties.

   But they don't realize that there are provisions in the operative documents which are inconsistent and would thus annul tenancy by the entireties characterization and protection.

   Common examples of this are:

   (a) By the rules of tenancy by the entireties, the joint interest must pass outright solely by the surviving spouse in the event of the death of the surviving spouse. Oftentimes an operational document will provide that on the death of a member, the interest of that member must be sold. Agreements are commonly not drafted to explicitly provide that on the death of a spouse, the other spouse will be the owner of the joint interests, without any inconsistent member agreement provisions.

(b) Similarly, provisions under an operative document which restrict transfers may actually be read to prevent one spouse from owning the entire member interest on the death of another spouse.

(c) While the certificate of ownership may be issued to both spouses as tenants by the entireties, oftentimes the Operating Agreements or Articles of Organization will provide for only one spouse or the other to be an owner.

2. ENTITY DOCUMENTS CAN DISQUALIFY S ELECTION.

Limited liability companies may be treated as S Corporations under the federal income tax law if certain very strict requirements are met and an S election is made.

If the S election is made but the S Corporation requirements are not met, then the company will be taxed as a "C Corporation," therefore exposing properties and income to double tax.

Common causes of this catastrophic treatment are as follows:

(a) An operating agreement does not provide for all income to be distributed pro rata to ownership. Commonly "partnership style" clauses assure members that they will recapture their original

investment or have some sort of an income sharing that would reflect a "second class of stock," which is not permitted under the S Corporation Rules.

(b) Although state law permits a limited liability company to have non-citizens, corporations, and other entities own LLC interests, these and certain other entities are not permitted owners of S Corporation stock, and will thus cause disqualification.

(c) Too high of a debt equity ratio could cause disqualification from S Corporation status.

3. FAILURE TO PLAN FOR CASH OR OTHER DISTRIBUTIONS/FAILURE TO USE AN INTERMEDIARY ENTITY.

Oftentimes a client will invest in a multiple member LLC, expecting to have charging order creditor protection, but not thinking through that positive cash flow that the other members will want to assure is distributed will become accessible to a judgment creditor who has a charging order against the LLC. Many clients are well advised to establish a "Family Holding LLC" or a family limited partnership to hold the multiple member LLC interests so that positive cash flow would pass to the family LLC, to be held and reinvested in a protected manner.

Clients who take ownership in a multiple member LLC as tenants by the entireties may wish to do so under a limited liability company or limited partnership owned by the spouses and another family member in order to assure that upon the death of one spouse tenancy by the entireties status would continue, and positive cash flow from the multiple member LLC will thus be protected.

4. FORCED SALE PROVISIONS.

Often well-drafted Operating Agreements will have provisions that would allow any member to force a sale of their member interest at any time or under certain circumstances, such as where another member is selling their

under certain circumstances, such as where another member is selling their interest ("tag along rights"). One advantage of a limited liability company under the laws of most states is that the sole remedy of a judgment creditor is a charging order – meaning that the creditor cannot actually force the sale of the limited liability company interest, become a forced owner, or reach into the limited liability company. A bankruptcy or state court judge may override charging order protection where a debtor member would have the right to simply "cash out" at the time when the judgment creditor has a charging order against the debtor.

5. **WE "FORMED IT OURSELVES" – OR "MY ACCOUNTANT TOOK CARE OF THIS."**

   While it is possible for any third grader to file a charter to establish the existence of an LLC with state authorities, in the author's experience the vast majority of LLCs that have been established by non-lawyer personnel have been implemented incorrectly. In most states it's the unauthorized practice of law for a non-lawyer to establish and implement a limited liability company for another party. Therefore, the types of non-legal firms that are willing to establish and implement limited liability companies tend to be unconcerned and ignorant, willfully or inadvertently, of the formalities, paperwork, and coordination needed to properly establish, document, implement and operate a limited liability company. Clients who buy $99 "Total Service Incorporation Kits" run the same risks. The slogan "Pay us now or pay us later" comes to mind, but along with that comes "Pay us later and watch your assets looted by creditors and/or the Internal Revenue Service."

6. **ASSUMING THAT LIMITED LIABILITY COMPANIES ARE AS WELL PROTECTED AS LIMITED PARTNERSHIPS IN ALL STATES.**

   Some states provide charging order protection for limited partnerships but not limited liability companies. Clients who have or will have children or other members residing in a state or jurisdiction that may not protect them may want to consider using limited partnerships or other entities in lieu of limited liability companies.

7. **FAILURE TO PROPERLY RESPECT FORMALITIES AND THE EXISTENCE OF THE LLC.**

   It is generally very difficult to "break the corporate veil," but a debtor relying upon a limited liability company arrangement needs to be able to show that the company was the actual owner and operator of the property and/or business, that a charter was properly filed and maintained consistent with operational documents, accounting and tax treatment, and that the arrangement was not in reality a general partnership, a joint venture, or a proprietorship.

8. **PERSONAL ACTIVITIES MAY NOT BE INSULATED BY USE OF AN LLC.**

   Some clients believe that they can carry on consulting, management, or related activities under the name of their LLC and not have potential personal liability. Under general tort law the officer of a company, and the manager of an LLC, will be responsible to third parties for personal negligence. Many clients are well advised to keep a low profile with respect to LLC activities, and to hire third parties to handle management decision making and day-to-day activities.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Alan Gassman

Edited by Steve Leimberg

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