

# Powerful Strategies with the Limited Liability Company

THE LIMITED LIABILITY COMPANY (LLC) has become a powerful tool for accomplishing many assets protection goals. The LLC is the most versatile and convenient strategy for owning rental property, insulating Dangerous Assets, operating a business, and achieving an excellent level of financial privacy.

## Background

The LLC is a relatively new legal entity created by statute and recognized in all fifty states. The adoption of the LLC format began in Wyoming and Florida in the 1970s with approval in most other states only within the last ten years. The purpose of the legislation is to allow individuals to create a legal entity that avoids many of the tax and business problems inherent in the corporate and partnership structure. The intent of the law is to allow individuals to conduct their financial and business affairs in an efficient and convenient manner without the restrictions, formalities, and liabilities associated with those other entities.

More particularly, the LLC provides *the protection from liability* of a corporation without the formalities of corporate minutes, bylaws, directors, and shareholders. In contrast to corporate law, which allows, shareholders and officers to be individually sued if the corporate formalities are not followed, the LLC law specifically bars a lawsuit against a member for the liabilities of the LLC. That is an important distinction which you should understand. The principle shareholders and officers of a corporation are routinely named as defendants in a lawsuit against the company—forcing them to incur attorney’s fees to defend themselves and rendering the corporate shield meaningless from a practical standpoint.

A primary goal of the LLC legislation was to change this result by clearly stating that the members and managers of the LLC could not be named in a lawsuit against the company. The new law was drawn specifically to provide a vehicle which would protect the owners from liability associated with the business—what the corporation was intended for but no longer accomplished.

The LLC is also convenient to maintain. The owners are permitted to adopt flexible rules regarding the administration and operation of the business. For tax purposes, it is treated like a partnership. That means the LLC itself pays no income tax. All of the income and deductions flow through directly to the members and is reported on their personal tax returns.

The LLC is formed by filing Articles of Organization with the Secretary of State’s office. Unlike the FLP, which requires the names of the general partners, the disclosure of the names of the principals can be avoided. The name of *either* the members or the manager must be provided in the articles. Also, many states, including Nevada and Delaware, permit a single member LLC to be formed. We will see that those provisions open the door for a variety of financial privacy strategies. Anonymous ownership of financial

accounts, business interests, and real estate can be achieved with an LLC as an important component of the plan.

The bad news, for physicians and some other professionals, is that state law generally does not allow these practices to be operated as an LLC. The liability shield available to business owners has not been extended to doctors—due to opposition primarily from the trial lawyers. Although the LLC may be useful in protecting accumulated assets from lawsuits, it will not insulate the individual from the Liability associated with a medical practice.

## The LLC Compared to Other Techniques Inside and Outside Liability

To understand the benefits available from the LLC, let's look at a typical example. John and Mary own an apartment building as tenants-in-common. We know that holding the property, as they do now, exposes them to great danger. Ownership of rental property creates more uncontrolled liability and lawsuit risk than any other business or profession we have seen. And because this potential liability usually cannot be covered by insurance, a single unpredictable event, a mistake, or just bad luck can wipe out everything built up over the years.

Injuries to tenants, problems with leaders, lawsuits from future buyers—all subject everything that John and Mary own to potential liabilities from the property. We call this type of liability—arising from the property itself—*inside liability*. John and Mary need to be protected from *inside liability*.

To make matters worse, a lawsuit or claim against John or Mary from a matter not related to the building exposes the equity in the

apartment property to seizure in satisfaction of that claim. We call this type of liability *outside liability*. John and Mary's interests in the property must be protected from outside liability. If one of them is involved in an auto accident causing serious injury, they do not want to lose the property because of this outside liability. Clearly, owning the apartment building in the current manner is not sound business planning. What other options are available to them?

## LLC Versus Corporation

John and Mary could transfer the property to a corporation. Each would own 50 percent of the stock in the company. Since the law provides that the shareholders are not responsible for debts of the corporation, a liability arising out of the property would not subject John and Mary's personal assets to danger.

The problem is that this protection against liability is only available if all of the corporate formalities are carefully followed. Since most people do not maintain proper corporate records and documentation, corporations often do not provide the intended level of protection. Further, corporations are subject to complex tax rules, which can cause severe and unintended consequences.

Finally, the corporation will not protect the property from outside liability—lawsuits against John or Mary unrelated to the property. A creditor can simply seize the stock that they own and reach the apartment building by dissolving the company. For these reasons, it is generally not advisable to hold investment real estate in a corporation.

## LLC Versus Limited Partnership

If John and Mary form a limited partnership to hold the property, one or both of them will serve as general partner. Since the general partner has unlimited liability for the debts of the partnership,

if a liability arises out of the operation of the building, the general partner's assets will be exposed to that claim. The major problem with the limited partnership format is this unlimited liability of the general partner. From a tax standpoint, the limited partnership does not cause any difficulties and, as previously discussed, a creditor suing John or Mary for an outside liability would be limited to a charging order, which would not affect the property in the partnership.

## The Benefits of the LLC

By forming an LLC, John and Mary can accomplish all of their objectives.

### Protection from Inside Liability

A member of an LLC is not responsible for claims or judgments against the company. When we are dealing with a rental property or an active business, the potential liability associated with the business is a primary concern. But as we have stated, the law specifically provides that the members of the LLC cannot be sued. In our example, John and Mary transfer their apartment building to an LLC. If a tenant is injured in an accident, John and Mary, as members of the company, would be protected from and claim relating to the property.

### No Formalities

An LLC is not required to maintain formal minutes and resolutions. Record keeping requirements can be minimized without a threat that the members will be sued individually for a liability of the company. Contrast this treatment with that of a corporation. If the proper formalities are not followed, the corporate protection will be pierced and the owners will have liability for company obligations. The LLC law is specifically intended to remedy this

problem by providing that the entity cannot be pierced because of a failure to maintain any of the corporate type documents.

### Protection from Outside Liability

Property held in an LLC cannot be seized by a creditor of a member. If there is a judgment or claim against John or Mary, the creditor cannot reach the property held in the LLC. As is the case with the Family Limited Partnership, assets of the LLC are protected from potential claims against a member. The creditor is limited to the ineffective charging order remedy. A creditor with a judgment against a member of the LLC is only permitted to take whatever actual cash distributions are made by the company. The creditor cannot force a distribution or demand any portion of the assets of the company.

### LLC Examples

We will give you some real life illustrations to see how these points fit together.

Mrs. Drake was a seventy-five-year-old widow. She sold a duplex she had owned in California for many years for \$200,000 and used the money—her life savings—to move to Arizona and buy a condominium. Her only income was Social Security payments of \$1,200 per month, which she used to pay her living expenses.

Three years after the sale, the real estate market in California collapsed and the value of the duplex dropped by half. That shouldn't have mattered to Mrs. Drake since she had sold the property three years earlier. The new buyer was just unlucky when he lost his equity in the property.

But that's not how it works anymore. The buyer sued Mrs. Drake in California claiming that she had failed to disclose defects in the

property. None of these allegations were true. The reality was that the buyer had lost money when the market declined and he wanted it back. So he asked the court to rescind the sale contract—meaning that he wanted his \$200,000 back plus interest.

The lawsuit placed Mrs. Drake in a terrible position. To defend the case she would have to hire an attorney—and these types of cases are very expensive. She was told that legal fees to defend her would run from \$25,000-\$50,000—money she clearly could not afford. The buyer's attorney, on the other hand, was handling the case on a contingency—so the buyer really had no cost and nothing to lose by pursuing the lawsuit.

Rather than risk losing her home and the rest of her savings and knowing that the litigation costs alone could wipe her out, Mrs. Drake settled the case for \$70,000. She borrowed the money against the equity in her condominium and she now uses most of her Social Security check to make the monthly mortgage payment. Instead of a comfortable retirement enjoying her life, she lives a Spartan existence, barely surviving each month.

What did she do wrong? She sold her property at the top of the market. She should be rewarded for her good business sense. Instead, because she was an easy and a vulnerable target, the buyer and his lawyer managed to extort most of her life savings.

What should she have done? The outcome of the case would likely have been different if she had used an LLC to hold her Arizona condominium. The lawyer for the buyer would have determined that her assets (the condominium) were unreachable and without funds to pay a judgment she would not have been an attractive defendant. Additionally, the arrangement works so well from an asset protection standpoint, that even if Mrs. Drake had been sued by the buyer—and if she had lost—her home would

have been shielded from the judgment. Legal protection for assets is a plan that usually defeats these types of extortion attempts.

The next illustration involves a client, Dr. Bell, who owned a valuable medical office building for many years. He had paid about \$100,000 for it in 1970 and because of depreciation deductions it had a zero basis for tax purposes. In 1993, when he came to see us, the property had a value of \$1 million. He had two principle objectives. First, he wanted to protect this asset from any claims which might arise from his medical practice or personal activities. Second, he wanted to protect himself from any liability associated with the property. He didn't want to get sued because of some problem with the property and risk losing the other assets he had accumulated. He had no pending or threatened lawsuits or other immediate concerns. He was simply interested in developing a prudent business plan.

We felt that these objectives could be accomplished and as a part of his overall plan we put the office building into an LLC. His other assets including his savings were transferred into the Family Limited Partnership. We did not put the office building into the FLP because it is a Dangerous Asset and should not be mixed with Safe Assets.

In 1995, Dr. Bell got involved in some serious business problems because of a partner in a real estate venture. The partner refused to pay his share of the expenses and Dr. Bell was stuck with judgments and bills totaling more than \$1 million. The creditor with the judgment attempted to collect from him. Because the office building was in the LLC, the judgment lien did not apply to that property. He was free to sell, refinance, or deal with the property as he decided. His bank accounts and brokerage accounts were safely protected in the FLP. The judgment had virtually no effect on Dr. Bell's accumulated assets because he had engaged in the proper planning.

Compare the differences in this case that resulted from the strategy he used. If he had not put office building in the LLC, the judgment lien would have attached to the property. The creditor would have foreclosed on the property to collect the debt.

For income tax purposes, a foreclosure is treated like a sale for the amount of the debt. In other words, if the creditor has seized the office building, Dr. Bell would have been treated as if he had sold the property for \$1 million. His tax basis was zero so the taxable gain would have been \$1 million. Not only would he have lost the property with all that equity—he would have been stuck with a tax bill to the IRS of about \$300,000.

Instead he managed to shield his valuable assets and continue to defer the taxes on the office building. This is a dramatic example of the advantages which can be obtained by using the correct legal structure to protect valuable assets.

## Insulating Business Risks

The major criteria in selecting the entity within which to conduct a business is the degree of insulation offered from the liabilities of the business. If you already own a business or are planning to start one, do you want to place everything you own at the risk of the business?

Any business venture is a Dangerous Asset. There are leases to sign, bank loans, customers, employees, competitors, and government agencies—all with the potential to blow you sky high. You don't want the liabilities from this business to threaten your other assets. The proper strategy is to contain the liabilities within the

shield of the LLC. If something happens inside the company, make sure that it doesn't contaminate your savings and other assets.

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The purpose of asset protection planning is to allow you to engage in a business activity while protecting your other assets from the risks associated with the business. The proper plan enables you to pursue attractive investments and business opportunities without jeopardizing everything you own. Do you want to buy real estate or start a business? Understand your level of risk and then protect what you have. That's the sensible approach.

## Other Dangerous Assets Elderly Drivers

A client asked us to set up a plan for his elderly mother whom we will call Louise. She was eighty-four years old and owned a home and some savings. She was in good health and drove her car to do errands and visit with friends every day. Louise had been in two minor fender benders in the past three years and our client was concerned that there could be a more serious accident—one in which Louise or an innocent party would be injured.

In this case Louise's car was the Dangerous Asset, capable of producing a large lawsuit liability if she got into an accident. Since adequate insurance was impossible to obtain, it was necessary to create an asset protection plan which would protect Louise's home and savings if the worst happened. We put her home into a trust and her investments into an LLC. Six months later there was indeed an accident and both passengers in the other car had bruises and broken arms.

The lawyers for the plaintiffs ran an extensive asset search on Louise to see if they should proceed with the case. They found that there were no reachable assets, except her car; and they accepted the insurance company's offer of the \$100,000 policy lim-

its. Louise managed to avoid a devastating financial loss and she held on to her home and savings.

## SMALL INVESTMENTS CAN CREATE LARGE LIABILITIES

A physician client invested \$50,000 in a new restaurant. The arrangement was that he would put up this money and the other partner would run the business. The doctor did not realize that he would be fully responsible for all debts of the company—even if he never knew about or signed an agreement. In a general partnership, each partner is liable for all partnership obligations, even those incurred by another partner. And, not surprisingly, his partner signed a five-year lease for the restaurant and bought several hundred thousand dollars of equipment on credit. When the business shut down six months later, our client, as the only partner with any money, was responsible for the remaining lease payments and the equipment, all of which totaled more than \$500,000.

This case emphasizes that a relatively small investment can create a large liability. The restaurant investor analyzed the business deal based upon what could happen to his initial investment. He thought that in the worst case he would lose his contributions of \$50,000. He certainly didn't want that to happen but he was prepared to risk a certain sum of money. But the amount of the investment is only a part of the equation. He did not think about the extent of the risk to his personal assets created by the liabilities of the business. The real question should always be "How much trouble and how much money can this deal cost me?"

By now you know that the restaurant business should have been formed as an LLC rather than a partnership. As a member of the LLC, the investor would not have had any liability and could not have lost more than his initial contribution. The decision making

process involves understanding the legal risks which are created in the proposed business and creating the proper legal structure to contain those risks.

## Teenage Drivers

A client in the stock brokerage business set up a plan to protect his savings from potential liability associated with his business. He and his wife went to Mexico for a vacation, leaving his eighteen-year-old son at home. The son had a party, got drunk, and crashed the family car causing serious injury to three other people.

An automobile is a Dangerous Asset because anyone is capable of an accident that results in catastrophic injury. It is possible to cause injury that exceeds the amount of any reasonable insurance coverage. In particular, if there are teenage drivers, anyone who might drive while intoxicated, or an elderly driver whose abilities are somehow impaired, it is essential to isolate the auto from the other assets of the family.

## Keep Your Property Free from Attachments and Liens

The most powerful weapon of a potential legal adversary is the ability to freeze your assets. When your bank account is frozen, it means nothing can be moved. You cannot pay your bills or run your business or withdraw your money. Your residence, rental property, or business can also be attached. You can't collect rents or income, and your property cannot be sold or refinanced.

The plaintiff can attach your property *during* or *after* the lawsuit. An attachment during the case is known as a pre-judgment attachment. After the case is decided, it is called a judgment lien. A pre-judgment attachment is only granted in certain types of cases, generally those involving a contract dispute over a particular amount of money.

A judgment lien applies if the plaintiff receives an award in his favor. The judgment lien immediately attaches to all real estate in

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your name, all bank accounts, brokerage accounts, and other assets. A lien acts like a mortgage or trust deed. You cannot sell or refinance a property without paying off the creditor, and he can foreclose on the real estate and seize any accounts in your name. A creditor with a judgment lien clearly holds all of the cards. You have no leverage and no room to negotiate. At that point he has got you. You are trapped and there is no way out. Certainly that is not the position you want to be in when you deal with an adversary.

One of our clients, Ed, was a wealthy real estate investor and owned five apartment buildings worth about \$3 million. Although he was involved in a lawsuit concerning a property dispute at the time, he felt he had little exposure. We set up a plan for him using several LLCs to hold properties. A year later we received a call from Ed telling us that he had lost the case and there was a judgment against him for \$1.5 million. Had he set up the plan he would have been in big trouble. The plaintiff would have had a lien on all of the client's real estate, worth \$3 million, as security for the judgment. The property would have been frozen and then seized. The plaintiff would not have taken a penny less than the full amount of the judgment. Nothing to talk about or discuss—just pay up. That's a bad position to be in.

But because Ed was a smart guy, he was not in a bad position. Since all of his assets had been transferred into the plan, the judgment lien did not affect the properties. Ed was free to sell, refinance, collect rents, and deal with his property just like he had always done. Since the creditor had no security for his judgment and stood to collect nothing, Ed now had the leverage to negotiate a favorable settlement. He held all of the chips, and in fact, he settled the case for \$75,000—clearly a better result than losing the \$1.5 million. In this case the proper asset protection plan changed the relative bargaining power of each side. *Ed could have been*

*weak and vulnerable but instead was able to negotiate from a position of superior strength.*

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Another client, an architect, had savings of about \$75,000, which he had inherited from his mother. Architects have a high lawsuit risk, and our client needed to protect these funds for the care and special education of his eight-year-old child who had severe physical and learning disabilities. Sure enough, within two years after setting up the plan, my client was served with a lawsuit. The plaintiff attempted to get a pre-judgment attachment of the savings but the judge ruled that the assets were properly protected and could not be reached by a lien. Without any assurance of payment, the plaintiff's attorney quickly lost interest and the case was settled for under \$2,000.

These examples illustrate the importance of protecting valuable assets from pre-judgment attachments and judgment liens. Without access to your funds, you can't pay your household expenses and you can't operate a business. Worse, if you can't pay your lawyer to defend the case, you will be forced into an immediate and unfavorable settlement. The proper strategy allows you to maintain access to your funds and your property during and after litigation and that is sound financial and business planning.

## Tax Treatment of the LLC

All income of the LLC is passed directly through to the personal returns of the members. When property is transferred to the LLC or distributed from it, there are no separate tax consequences. Except in unusual circumstances, the general rule will apply and no gain or loss will be recognized on a contribution to or distribution from the company. There is no tax when funds are withdrawn from the company. The only tax paid is on the income earned, which is reported on the owner's personal tax return. This system avoids

the complications and potential double taxation that plagues the corporate format.

## Summary

In this chapter, we have discussed major benefits which can be accomplished with the LLC. Figure 6-1 illustrates the general plan which we have presented so far.

First, the LLC can be an important element of a plan that produces an excellent level of asset protection. Lawsuits and claims which are based upon a knowledge of your personal financial matters will be discouraged before they begin. When your assets are held in a protected form, a plaintiff or his lawyer looking for a Deep Pocket Defendant will not find any reachable assets when they investigate you. Since lawyers only sue if they believe they will be able to collect a judgment, using an effective plan will discourage most people from filing a lawsuit against you.