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How To Protect Your Assets With Limited Liability Companies: *The Never Revealed Secrets That Others Won't Tell*

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Background

Limited Liability Companies first appeared in the United States in, of all states, Wyoming in 1977. But Wyoming didn't invent LLCs, the concept actually originated in Germany and in some Latin American countries, which called them "limitadas". Some US oilmen liked the limitada concept in Panama and sought out the friendly legislature of Alaska to enact a limited liability company statute. Alaska didn't pony up, but Wyoming did and the rest is history. Texas adopted its first Limited Liability Statute in 1991. Now all 50 states and the District of Columbia have adopted LLC statutes.

Formation

A Limited Liability Company, or LLC, is an entity created under state law by the filing of a Certificate of Formation (it used to be called Articles of Organization in Texas) with the Secretary of State. You can file the Certificate of Formation online or by fax or mail with the Secretary of State and a filing fee of \$325 for expedited service. If you don't expedite the service (the extra \$25) it will take a couple of weeks to get it registered. With expedited service, you can be up and running in a couple of days. You also need a Company Agreement under which the LLC is to be operated. This can be oral. Not a good idea. The Company Agreement needs to be carefully drafted if the LLC is to be taxed as a corporation for federal income tax purposes.

LLCs are simple. There is no requirement for annual minutes like there is for corporations.

Taxation

An LLC with two or more members by default is taxable as a partnership, i.e. a flow-through entity for income tax purposes. This means that members receive their portion of income tax attributes of the LLC. The LLC will file an IRS form 1065 income tax return but does not pay income taxes. However it may also elect taxation as a C or S corporation. Similarly, a single member LLC may be taxable as a disregarded entity (schedule C on his or her 1040) or as a C or S corporation but not as a partnership. If the sole owners are a married couple in a community property state, the IRS considers it a single member LLC.

Asset Protection - Basic

Under state law, an LLC has certain features that affect both member (owner) liability for the company and creditor rights involving the company or even a separate liability of an individual who happens to be a member. Members of the company do not have personal liability for the enterprise. Instead, liability for company activities is limited to the assets of the company, i.e. a member's investment. Likewise, a member would not ordinarily have personal liability for company obligations absent a personal guaranty.

A Limited Liability Company provides considerable asset protection to members carrying on a business. The LLC limits the personal liability of the owners to the Company's creditors as pointed out above since members risk only their investment in the LLC to the creditors of the company. An LLC also provides some protection from the judgment creditors of the individual members if a judgment is entered against the member after the creation of the company for something unrelated to the LLC.

LLCs protect family assets from claims of future creditors of members as a result of basic equitable principles. For example, if future creditors of a particular member were able to acquire assets, all the members would suffer as a result of the actions, or inactions, of a single member. Basic equitable concepts do not support punishment of an innocent group of members for the actions of another member.

The LLC provides asset protection by dictating the rights of a member's creditor. Creditors of a member have no right to become a member, to demand company assets, or to compel distributions.

Texas law provides that a judgment creditor may only levy on assets that are distributed out of the company to the member or may obtain a charging order from a court to that effect. A corporation has no such statute. For many professionals, and for people with wealth, the asset protection features of the LLC are often the most substantial business purpose for creation of the entity. Nevada and Delaware statutes provide that the charging order is the SOLE remedy for a creditor of an owner of an LLC. Texas law is not so explicit, so some advisors only recommend forming an LLC under Delaware or Nevada or a couple of other states like South Dakota and Wyoming. This requires additional filing fees and maintenance fees.

Recent Real Life Cautions

Recently, a Colorado bankruptcy judge looked through a single owner LLC into the assets of the LLC for the owner who filed for bankruptcy on the theory that the purpose of the LLC statute in Colorado was to protect the business endeavor from disruption on the basis that it wouldn't be fair to an owner of an LLC who had no creditor problems to be forced to liquidate the business because of the creditors of another owner. In this case there was only one owner. The original Texas LLC statute had similar purposes. Texas has codified all businesses into the new Texas Business Organizations Code, which has no such language. Based upon this Colorado bankruptcy case, many advisors recommend that an LLC should always have more than one owner.

A Texas judge has recently done something similar to a client of mine. He ordered the Sheriff to liquidate the assets of a limited liability company and pay them to the creditor of the owner. Fortunately, the Sheriff didn't comply because the judgment was against my client individually and the assets were in the name of the Company and there was no judgment link between the two.

Other Advanced Tips

Remember this rule: A creditor can always get to the owner of an asset, and the creditor can also generally get to other assets owned by the owner. If the LLC owns real estate, a judgment creditor of the LLC can levy on the real estate. If that is all the LLC owns, then there are no other assets for the creditor to get, but if the LLC owns many assets, they would all be at risk. To avoid the danger of "all eggs in one basket" an LLC may be structured with subordinate entities to own "risky" assets, i.e. those that create liability. The preferred solution is for the LLC to own one or more subordinate limited liability companies. An asset protection design can involve wholly-owned subordinate LLCs

(taxable as disregarded entities) to hold risky assets. Since this is the lawsuit risk faced by the LLC, the LLC contains the risk and protects both the other LLC assets and the Owners. The LLC is the property owner, so only the assets of the LLC would be at risk. Create your own “Bank” LLC to be the lender to any other LLC you own for operating capital and take a lien back against the LLC assets to secure the loan. A creditor of the LLC will have to pay off the loan to the Bank LLC first before satisfying its judgment.

Other Benefits

An LLC can be used to reduce the size of the estate of the owner through discounts for lack of marketability and, possibly, lack of control. This can result in lower estate tax exposure.

An LLC can be considered a security under Texas law, so contributing Uniform Transfers to Minors Account assets to an LLC before the minor attains the age of control can allow you to defer complete control over the funds at an inappropriate age or time for the minor.

An LLC can be an effective tool in which to put assets that are to be given to children by elderly parents that may want to qualify for Medicaid for nursing home assistance, instead of fractionalizing the funds between children who may or may not manage the funds well. This way the Manager of the LLC can keep control of the gifted assets to ensure availability for needs of the family as a whole.

This article has been a brief overview of the benefits of LLCs. There are many other benefits that are too numerous to consider in this Article. Contact us to find out more. Call 713-461-9699 to schedule an appointment today. We offer a 1-hour initial conference at no charge to discuss your asset protection issues. WealthKeepers® is an asset protection and wealth transfer planning firm.

James C. Mulder, a Houston based attorney with over thirty years of experience in Wealth Transfer, Tax and Asset Protection Planning is Board Certified by the Texas Board of Legal Specialization. He is one of only nine attorneys in the Houston area that are Board certified in both Estate Planning and Probate Law and in Tax Law. Mr. Mulder concentrates his practice primarily in the areas of Wealth Transfer, Tax and Asset Protection Planning, which includes the development and preparation of very comprehensive Wills and Trusts, Business Organizations and Family Partnerships. Mr. Mulder has prepared over 1,000 asset protection plans.