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ASSET PROTECTION PLANNING WITH LIMITED LIABILITY COMPANY STRUCTURES

CHRISTOPHER M. RISER, M.A., J.D., LL.M.
MAYER & RISER, PLLC
POST OFFICE BOX 750
511 SMALLWOOD AVENUE
HIGHLANDS, NORTH CAROLINA 28741
(828) 526-3731
(828) 526-3734 FAX
WWW: HTTP://WWW.MAYER-RISER.COM
E-MAIL: CRISER@MAYER-RISER.COM
THE RISER REPORT: HTTP://WWW.RISERREPORT.COM

CHRISTOPHER M. RISER, M.A., J.D., LL.M.

Chris Riser is a member of the law firm of Mayer & Riser, PLLC in the North Carolina mountain resort town of Highlands, where he concentrates his practice in the areas of asset protection planning and tax planning. Mr. Riser is admitted to practice law in North Carolina. He is also admitted to practice law as a Solicitor of the Supreme Court of England and Wales.

He received his A.B., with Distinction, in Russian and Slavic Linguistics (Phi Beta Kappa), as well as his M.A. in Slavic Linguistics, and his J.D. from the University of North Carolina at Chapel Hill, where he is a Fellow of the Center for Slavic, Eurasian and East European Studies. Mr. Riser received his Master of Laws in Estate Planning from the University of Miami. He is Gulf War veteran of the U.S. Army's XVIII Airborne Corps.

Mr. Riser has published a number of articles on tax planning and asset protection planning in professional journals in the U.S. and the U.K. He is a regular continuing professional education speaker. He also is the publisher of a popular free internet newsletter, The Riser Report, available at http://www.riserreport.com.

Mr. Riser is a member of the ABA RPPT Section's International Estate Planning Committee and the Asset Protection Planning Committee, for which he is the Internet Coordinator. He is also a member of the ABA's Tax Section and Business Law Section.

CONTACT INFORMATION:

Christopher M. Riser
Mayer & Riser, PLLC
Post Office Box 750
511 Smallwood Avenue
Highlands, North Carolina 28741
(828) 526-3731
(828) 526-3734 fax
WWW: http://www.mayer-riser.com
E-mail: criser@mayer-riser.com
The Riser Report: http://www.riserreport.com

ASSET PROTECTION PLANNING USING LIMITED LIABILITY COMPANY STRUCTURES

CHRISTOPHER M. RISER, M.A., J.D., LL.M.

Everywhere you turn for information about tax planning, business planning and asset protection planning, you're hearing about limited liability companies (LLCs). So, what's so special about LLCs? For the first time, U.S. businesses can qualify for unrestricted passthrough taxation and obtain limited liability for their owners.

To see what makes LLCs so attractive, it helps to compare LLCs to other available forms of business entities, particularly corporations and partnerships.

BASIC LEGAL AND TAX CHARACTERISTICS OF BUSINESS ENTITIES

CORPORATIONS : NON-TAX CHARACTERISTICS

The corporation is a business entity with a legal existence and identity that is separate from its owners. It is characterized, generally, by a tripartite structure which separates ownership from management and the day-to-day business of the corporation. A corporation's owners, the shareholders, elect a governing body, the board of directors, which oversees the general management of the corporation. The board of directors appoints officers who oversee the day-to-day business of the corporation and have the authority to transact business on behalf of the corporation.

Ownership of a corporation is represented by shares of stock. There can be different classes of shares with different voting rights and different economic rights. Transfers of stock are generally not restricted by statute, but often are restricted in the corporation's governing documents and in the stock certificates themselves. The death or bankruptcy of a shareholder has no effect on the existence of the corporation.

The shareholders of a corporation have limited liability for the debts of the corporation. That is, they can only lose what they've invested. Of course, if a shareholder has personally guaranteed a corporate debt, the personal guarantee can cause the shareholder to be personally liable for more than his investment in the corporation. As a practical matter, most shareholders of small corporations are required to personally guarantee contractual obligations of the corporations.

Limited liability for the owners of a corporation does not mean that the corporation will not be liable for the actions of its employees nor that a shareholder, officer or director will not be liable for his or her own actions. As mentioned above, a shareholder may be personally liable because he or she personally guaranteed a loan or line of credit. An

owner will be liable for his or her own personal misconduct as well, including negligent hiring and supervision of employees.

Finally, limited liability will not apply if the shareholders of a corporation do not treat the business as a separate entity. For example, if the business is grossly undercapitalized, if the owners mix business and personal funds, or if the business fails to keep proper business records, it is possible that a court may find that the corporation is merely the "alter ego" of its owners, and as such the owners of the business will be liable for the debts of the business. This problem is a relatively easy to avoid – simply keep business activities distinctly separate from personal activities.

If all of these bad things can happen, what good is limited liability? Limited liability protects owners from contractual debts of the company. If the company fails to pay for goods or services, the owners will not be personally liable – unless, of course, they personally guaranteed the debt. Limited liability also protects owners from tort liability related to the company to the extent that they were not personally involved in a bad act.

Limited liability also protects business owners from the misdeeds of other owners and employees (absent some claim like negligent hiring or supervision). If one owner or employee is making a delivery and runs over a brain surgeon, the corporation may lose everything, and that owner or employee may lose everything, but the personal assets of the other owners are not at risk. The limited liability offered by corporations is not complete, but it is certainly a valuable feature.

Since limited liability is a very important concept, let's look at a few examples. For purposes of later discussion, keep in mind that the discussion of limited liability above and the results in the examples below would be the same if the businesses involved were organized as corporations or as LLCs.

EXAMPLE 1

John and Jane, owners of J&J, Inc. operate a lemonade stand. Due to financial troubles, J&J, Inc. failed to pay for a large shipment of lemons from Juicy Lemons, Inc. Juicy Lemons, Inc. sued J&J, Inc. and won a judgment against the corporation for the amount of the invoice. The corporation must pay the judgment.

If the corporation does not have sufficient assets to satisfy the judgment, John and Jane will not be forced to cough up money from their own pockets, since the corporation, and not its owners, owes the debt. However, the $1,000 they each invested in the company is at risk to satisfy the judgment.

EXAMPLE 2

J&J, Inc. manages to turn itself around and satisfies the judgment in favor of Juicy Lemons, Inc. J&J, Inc. even expands its services to include lemonade delivery. J&J, Inc. takes on two employees, Spike and Mike, as drivers, and purchases two new delivery vans. In order to finance the corporation's purchase of the vans, the bank required that John and Jane each personally guarantee the loan.

While on a delivery run, Spike speeds through a stop sign and runs over Ann. After the police call John to inform him of the accident, he rushes off to the scene. In his haste, John negligently runs over the policeman at the scene.

Despite the fact that John was on company business, he is still personally liable for damages suffered by the policeman. Furthermore, it turns out that Spike's driver's license was revoked for reckless driving, and that, as a pizza deliveryman, he had run over a pedestrian a year ago. John and Jane never checked Spike's driving record.

Ann sues Spike for negligently injuring her by striking her with the van. She also sues J&J, Inc., as Spike's employer, since J&J, Inc. is vicariously liable for the actions of its employees in the course of business. Finally, Ann also sues John and Jane for negligently hiring Spike. Ann prevails against all parties, who are all jointly and severally liable for the judgment.

Since Spike has no assets against which Ann can collect, she cleans out J&J, Inc., then moves on to John and Jane personally, who are then forced to cough up personal assets to satisfy the judgment in favor of Ann.

Finally, the corporation is unable to make payments on the vans. The bank, therefore, can sue and collect from John and Jane personally since they personally guaranteed the loan.

TAXATION OF C CORPORATIONS

Under Subchapter C of the Internal Revenue Code, a corporation is treated as a separate taxable entity. The corporation itself is a taxpayer separate and distinct from its shareholders. Thus, income generated by the corporate business is taxed twice. It is taxed once when earned by the corporation and again when distributed to the shareholders. This

is quite different from the passthrough taxation treatment of sole proprietors and partnerships, which is discussed later.

Another major tax issue with regard to corporations is the taxability of an exchange of property for stock. A corporation recognizes no gain or loss on the receipt of money or property in exchange for its stock. However, nonrecognition treatment applies to the transferor(s) only if (1) the property is exchanged solely for stock in the corporation, and (2) immediately after the transfer, the transferor(s) controls the corporation. Control for these purposes is defined as ownership of stock possessing at least 80% of the total combined voting power of all classes of voting stock and at least 80% of the total number of shares of all nonvoting classes of the corporation's stock. If shareholders are going to contribute appreciated assets to a corporation, careful consideration must be given to these rules.

TAXATION OF S CORPORATIONS

Passthrough taxation describes the situation in which the tax items of a business – income, deductions, credits, etc. – are passed through to the owners of the business rather than taken into account separately by the business itself. Passthrough taxation is often advantageous for business owners because it ensures that only one level of tax will be paid on the income of the business.

Passthrough taxation is available under the U.S. federal income tax system for partnerships as well as for certain eligible corporations ("S corporations") that have elected to be taxed under the passthrough regime of Subchapter S of the Internal Revenue Code. However, only certain corporations qualify to be treated as S corporations and certain unfavorable restrictions are placed on the ownership structures of S corporations. For example, an S corporation may issue only one class of stock, may not have more than 75 shareholders, may not have non-resident alien shareholders, and may not have a partnership as a shareholder.

PARTNERSHIPS: NON-TAX CHARACTERISTICS

A partnership is an association of two or more persons carrying on a business venture as co-owners for profit. Partnerships come in two basic varieties, general and limited.

A general partnership consists only of general partners. In a general partnership the owners control the business and there is no statutorily mandated separation of ownership and management as there is in a corporation. Management of a general partnership is vested in all of the general partners. All partners of a general partnership are

jointly and severally liable for the debts of the business and for the wrongful acts committed by other partners in the course of the partnership's business. Thus, the personal assets of a general partner are subject to the claims of the partnership's creditors.

A limited partnership consists of at least one general partner and at least one limited partner. The management and control of a limited partnership is vested in its general partner(s) and cannot be vested in the limited partners. The liability of a general partner in a limited partnership is the same as in a general partnership. Whereas general partners have unlimited liability for debts of the limited partnership, limited partners have limited liability for debts of the partnership. However, a limited partner risks losing his limited liability if he participates in the management of the partnership's business.

A general partner (whether in a general partnership or a limited partnership) must obtain the consent of all the other partners to transfer his or her general partnership interest and grant to the transferee all of the his rights as a partner in the partnership. Also, the death, retirement, bankruptcy or withdrawal of a general partner causes the partnership to dissolve. A partnership agreement may, however, alter these rules.

A limited partner may freely transfer his limited partnership interest without dissolving the partnership. However, such a transfer normally results only in a shift in the limited partner's economic rights in the partnership (rights to profits, losses, and liquidation proceeds), unless the general partners agree to treat the assignee as a substitute limited partner, and confer on the assignee all of the additional rights of a limited partner, such as the right to vote on non-management matters.

PARTNERSHIP TAXATION

Partnerships receive passthrough tax treatment. The tax items of a partnership's business – income, deductions, credits, etc. – are passed through to the partners, so that only one level of tax is paid on the income of the partnership's business. Generally, there is no recognition of gain on the contribution of appreciated assets to a partnership. There are two important exceptions to this general rule. First, if a partner is relieved of liabilities in excess of the basis of the property he contributes to the partnership, he will recognize gain to that extent. Second, if the effect of forming an investment partnership is that the partners diversify their assets, there may be recognition of gain on the contribution of assets to the partnership in exchange for partnership interests under Section 721(c) of the Internal Revenue Code.

LIMITED LIABILITY COMPANIES: NON-TAX CHARACTERISTICS

The limited liability company ("LLC") is a hybrid type of legal entity that combines certain traits normally associated with corporations with other traits normally associated with partnerships and other non-corporate legal entities. LLCs allow their owners (called "members") to have the best of all worlds: passthrough taxation, limited liability, flexibility in ownership and management structure, and personal asset protection.

While corporate statutes are generally written to accommodate the needs of businesses with large numbers of passive stockholders, LLC acts are generally written with small businesses in mind. Thus, the LLC tends to be a more flexible and understandable business entity.

LLCs are managed in one of two general ways:

- Collectively by the LLC's members (a member-managed LLC); or
- By one or more appointed or elected managers (a manager-managed LLC).

While a manager of a manager-managed LLC typically is also a member, under the LLC acts of most jurisdictions, a manager need not be a member. So, while a corporation generally is operated with two levels of decision-making (board of directors and officers), an LLC can be operated with only one level of decision-making.

LLC HISTORY

Although the LLC is relatively new in the U.S., the concept has been around for over one hundred years in Europe and Latin America. Have you ever seen the name of a German company that ends with the abbreviation *GmbH*, or a Latin American company that ends with the abbreviation *SRL*? *GmbH* stands for the German phrase *Gesellschaft mit beschränkter Haftung* – literally, 'company with limited liability.' *SRL* stands for the Spanish phrase *sociedad de responsibilidad limitada* – literally 'limited liability company.'

In the mid-1970's a company in Wyoming dissatisfied with its available legal entity choices decided that it would be useful to have a statutory business entity form that would provide all owners with limited liability while allowing the owners to be treated as partners for tax purposes. The result was the passage in 1977of the Wyoming LLC Act, the first LLC act in the U.S.

The limited liability features of the Wyoming LLC were, of course, built into the LLC Act. However, the IRS determined the tax treatment of this new type of entity on a case-by-case basis. The Wyoming company that started it all applied to the IRS for a private ruling determining that the LLC would be taxed as a partnership. Eleven years

later, the company finally received a favorable ruling. At the same time, the IRS issued Revenue Ruling 88-76, which spelled out the requirements for taxing an LLC as a partnership.

With the issuance of Revenue Ruling 88-76 and the tax certainty it provided, the floodgates opened and an unprecedented torrent of new legislation issued forth. By 1996, every state in the U.S. had an LLC act. Legal and tax advisors scrambled to learn how to use this new entity.

Finally, in December 1996, the IRS issued the "Check-the-Box" regulations, which allow an LLC simply to choose whether to be taxed as a partnership or as a corporation. There are no hoops through which LLCs must jump for income tax purposes. Simply check a box or not – that's all it takes to choose the tax treatment of an LLC. With the advent of "Check-the-Box," the LLC is fast becoming the business, estate planning and asset protection entity of choice.

OFFSHORE U.S.-STYLE LLCS

ANGUILLA

Although many offshore jurisdictions had non-corporate limited liability entity statutes (like the SRL), none were very familiar to U.S. legal and tax practitioners. Sensing that the Wyoming-style LLC was going to be the future business entity of choice for Americans, a few offshore jurisdictions enacted U.S.-oriented LLC legislation. Anguilla adopted its LLC Act in 1994 and amended it in 1999. The Anguilla LLC Act was modeled on the Wyoming LLC act, which in 1994 was not one of the more modern U.S. LLC acts. The Anguilla LLC Act is also not favorable for use in estate planning. As a result, the Anguilla LLC is not often used.

ISLE OF MAN

The Isle of Man adopted its LLC act in 1996. The Manx LLC act is modeled on Manx partnership law, which is, in turn, modeled on English partnership law. As a result, the Manx LLC act looks unlike U.S. LLC acts. In addition to being generally unfamiliar to U.S. persons and practitioners, the Manx LLC act has a number of provisions which many U.S. persons would find objectionable.

Probably the most important of these objectionable provisions are that (1) Manx LLCs must have two or more members; and (2) Manx LLCs must keep certain accounting records in the Isle of Man. Nearly all of the U.S. LLC acts as well as the LLC acts of Nevis and Anguilla allow for single-member LLCs. Accounting records, including daily

entries of receipts and expenditures, a balance sheet, and annual inventories, must be kept in the Isle of Man. Failure to comply with the statutory accounting requirements subjects every member and manager of the LLC to criminal sanctions including imprisonment and large fines. Neither U.S. LLC acts nor those of Anguilla and Nevis contain such mandatory accounting provisions.

NEVIS

The Nevis LLC Ordinance, enacted in 1995 and amended in 1999, is based on the Delaware LLC act. In 1995, the Nevis LLC Ordinance was perhaps the most advanced U.S.-style LLC act available to U.S. practitioners. Five years later, many U.S. states have taken drastic steps to improve their LLC statutes. The Nevis LLC Ordinance, however, it is still one of the better LLC acts in existence. The Nevis LLC act was drafted to provide maximum flexibility, maximum estate planning advantages and maximum asset protection. In the offshore LLC world, the Nevis LLC Ordinance stands head and shoulders above other LLC acts.

OTHER OFFSHORE LLC ACTS

Other offshore jurisdictions have European-style LLC acts or hybrid company acts (companies limited by stock and by guarantee, etc), including, for example, Barbados, Panama and the Cayman Islands. Many of these statutes (such as the handful of limited duration company (LDC) acts that were enacted) came into place or were amended only a year or two before the check-the-box regulations came into effect. With the advent of check-the-box in the foreign arena, many of these non-U.S.-style LLC acts are basically obsolete for many U.S. purposes. Now, there is a wide range of foreign companies which can provide their owners with limited liability and passthrough taxation, and these are not just U.S.-style LLC acts.

The Marshall Islands enacted U.S.-style LLC legislation in 1996, but like Anguilla's LLC act, it has not been much used because of the popularity and superiority of the Nevis LLC Ordinance. The Cook Islands is expected to enact U.S.-style LLC legislation in the near future. It is likely that other jurisdictions will enact U.S.-style LLC legislation, promoting a healthy competitiveness to produce the most advanced cutting-edge LLC act in the offshore world.

LLC TAXATION

U.S. LLCs

Under prior law regarding the tax classification of business entities, LLCs were classified as corporations or partnerships for tax purposes based on the individual characteristics of each LLC. If the owners wanted partnership taxation, a minimum number of requirements had to be met. If the owners wanted corporate taxation, different requirements had to be met. The provisions of the particular LLC act under which an LLC was formed was important for tax classification, especially in cases where there was no LLC operating agreement or only a basic LLC operating agreement. All of this changed at the end of 1996, when the Check-the-Box rules (Treas. Reg. § 301.7701-3) were enacted.

Under the Check-the-Box rules, U.S. corporations are taxed as corporations and cannot elect to be taxed otherwise. However, any other business entity that is not properly classified as a trust or otherwise subject to special treatment under the Internal Revenue Code may elect its tax treatment. A separate business entity with two or more members can generally elect to be classified as either a corporation or a partnership. An entity with only one member does not qualify as a partnership. However, such a single-owner entity may elect to be classified as a corporation or to be disregarded as an entity separate from its owner and thus to be taxed as a sole proprietorship.

If a new entity fails to elect classification, it is classified under a set of default rules generally providing that domestic entities with two or members are classified as partnerships and domestic single member entities are disregarded as entities separate from their owners.

Basically, it really is that simple. If you want passthrough partnership or sole proprietorship taxation for a domestic LLC, you do nothing. In that case, it's really a "don't check the box" rule.

If an LLC wants to be taxed as a corporation, it simply files a one-page Form 8832, Entity Classification Election (included at the end of this outline), within 75 days after the date the election is to be effective, literally checking a box to elect to be taxed as a corporation. Once an LLC elects to be taxed as a corporation, it is a corporation for all federal tax purposes. So, a domestic LLC that has elected to be taxed as a corporation can elect to be taxed under Subchapter S as an S corporation as well (assuming it otherwise qualifies under the Subchapter S rules).

A brief mention of entity conversions is in order here. If a general or limited partnership converts to an LLC under local law, the resulting LLC will be taxed as a

continuation of the former partnership, unless the resulting LLC chooses to be taxed as a corporation, in which case the conversion will be treated as a dissolution/liquidation of the partnership followed by a contribution by the partners to a new LLC.

If a corporation converts to an LLC under local law, the resulting LLC can elect to be taxed as a corporation, thus causing the conversion to be treated as a continuation of the former corporation, with no tax consequences. If the resulting LLC does not elect to be taxed as a corporation, however, the conversion will be treated as a dissolution/liquidation of the corporation (with the potential resulting tax disaster caused by the liquidation distribution of appreciated assets) followed by a contribution by the former shareholders to a new LLC.

Single-member entities that do not elect to be taxed as corporations are completely disregarded for tax purposes. The simplest example is an LLC with one member, an individual person. In such a case, the tax items of the LLC are the tax items of the individual. The individual simply reports the tax items of the LLC on his own personal income tax return – business activity on Schedule C, capital gains and losses on Schedule D, rental activity on Schedule E, etc.

Another entity, such as another LLC or a partnership or corporation, can be the single member of an LLC. In that case, the LLC's tax items are reported on the underlying entity's tax return, just as with an individual owner. The tax items of an LLC wholly owned by a corporation, for example, will be reported on the corporation's Form 1120, U.S. Corporation Income Tax Return, along with the corporation's other tax items.

Taking the concept a step further, consider the LLC which is owned by more than one legal owner, all of whom are treated as one for tax purposes. This type of LLC can also be disregarded under the check the box rules. This concept is best illustrated by example.

EXAMPLE 3

Fred decides to do some estate planning and sets up a trust for his children. His estate planning advisor recommended that the trust be a "grantor trust" for income tax purposes so that the income of the trust would be taxable to Fred, rather than being taxed at the compressed trust income tax rates. The trust, the Fred Family Trust, was drafted to make it a grantor trust taxable to Fred under the rules of §§ 671-679 of the Internal Revenue Code. Fred's wife, Wilma, is the trustee. Fred funded the trust for several years and now the trust principal has grown to about $500,000.

Fred has $100,000 of his own funds that he would like to invest in a rental property. Wilma, as trustee of the trust, thinks it would be a good investment for the trust as well, and since the trust document gives her wide latitude with trust investments, she decides that the trust will invest $100,000 as well.

Fred and Wilma, as trustee, decide to form Bedrock Investment Properties, LLC, with each as a 50% member. They choose not to have the LLC taxed as a corporation, so they don't file a Form 8832 for the LLC. The LLC will be taxed as a disregarded entity with respect to Fred. Fred is treated as the owner of the assets of the grantor trust and he is, of course, the owner of his LLC interests. So, Fred is treated as the owner of 100% of the LLC interests, even though he does not control all 100% of the interests.

EXAMPLE 4

Let's make it even more complex. Wilma decided she needed to do a little estate planning as well. She set up a trust, the Wilma Family Trust, and she, Fred and their estate planner agreed, for whatever reason, that Fred should have a general power of appointment over the assets of the new trust Wilma was going to settle. They set up the trust that way, and Wilma, as trustee, formed an LLC, Granite Properties, LLC, of which her trust was 100% owner, which purchased another rental property.

Also, Fred has set up another LLC, Marble Properties, LLC, this time with Fred as 100% owner, to purchase yet another rental property. Fred and Wilma decide to form a holding company LLC, FW Holding, LLC, for all of the LLC interests. Wilma, as trustee of the Fred Family Trust, contributes the 50% interest in Bedrock Properties, LLC to FW Holding, LLC. Fred contributes his 50% interest in Bedrock Properties, to FW Holding, LLC. Wilma, as trustee of the Wilma Family Trust, contributes the 100% interest in Granite Properties, LLC to FW Holding, LLC. Fred contributes his 100% interest in Marble Properties, LLC to FW Holding, LLC. Now there are 3 legal owners of FW Holding, LLC – Fred, Wilma, as trustee of the Fred Trust, and Wilma, as trustee of the Wilma Trust.

This legal octopus known as FW Holding, LLC is taxed as a disregarded entity with respect to Fred, unless, of course, the LLC

chooses to be taxed as a corporation. Why? Even though Wilma settled the Wilma Family Trust, the fact that Fred has a general power of appointment over the trust principal causes him to be taxable on the trust's income under § 678 of the Internal Revenue Code. As we saw in the previous example, Fred is also treated as the 100% owner of Bedrock Properties, and he is of course, the 100% legal and tax owner of Marble Properties, LLC. Thus, for tax purposes, everything in FW Holding, LLC is taxable to Fred on his individual income tax return.

TAXATION OF OFFSHORE LLCS

In Treas. Reg. § 301.7701-2(b)(8)(i), there is a list of foreign entities which are classified as per se corporations and are not eligible elect passthrough treatment. The "per se" list includes a few entities occasionally encountered in the offshore world, e.g., the Costa Rican Sociedad Anonima. However, most offshore entities, including all offshore LLCs and international business companies (IBCs), are eligible to elect passthrough tax treatment.

A foreign entity that is not classified as a corporation under the regulations (an "eligible entity") can choose its classification for federal tax purposes by filing Form 8832 within 75 days after the date the election is to become effective. A foreign eligible entity with at least two members can elect to be taxed either as a corporation or as a partnership. An eligible entity with a single owner can elect to be taxed as a corporation or to be disregarded as an entity separate from its owner.

Unless the entity elects otherwise, a foreign eligible entity is:

- taxed as a partnership if it has two or more members and at least one member does not have limited liability;
- taxed as a corporation if all members have limited liability; or
- disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

Most dealings of U.S. persons with foreign entities will be with entities in which all members have limited liability (e.g. an LLC or IBC). Therefore, most foreign entities with U.S. owners must affirmatively elect passthrough tax treatment on Form 8832.

TAXATION OF LLCS TAXED AS FOREIGN CORPORATIONS

Is there any reason why U.S. owners of an offshore entity would want the entity to be taxed as a corporation? What if the U.S. owners of a foreign eligible entity wanted passthrough treatment but forgot to file Form 8832 or filed a defective Form 8832?

Some U.S. owners of foreign entities may want to have an entity taxed as a corporation if the corporation is conducting a business activity for which income tax deferral is allowed under U.S. tax laws or if U.S. ownership is small enough to allow the U.S. owner(s) to defer tax. Generally, for most U.S. persons interested in using offshore LLCs and other offshore entities as asset protection vehicles for cash and passive investments, no tax deferral is available simply by virtue of transferring U.S. assets to offshore entities. Therefore, U.S. owners usually will want to be sure that the entities are taxed as passthrough entities by properly filing Form 8832.

OFFSHORE LLCS TAXED AS CONTROLLED FOREIGN CORPORATIONS

If the typical U.S.-owned foreign LLC or IBC fails to elect passthrough tax treatment, it most likely will be a controlled foreign corporation (CFC) for U.S. tax purposes. Certain kinds of undistributed earnings and profits of a CFC (known as Subpart F income) are taxed directly to the CFC's U.S. shareholders.

Subpart F income includes passive income, net gains from the sale of stock and securities and from property that does not generate active income, related party factoring income, certain rents and royalties, net commodities gains, and net gains from certain foreign currency activities, net income from notional principal contracts, and payments in lieu of dividends derived from securities lending transactions. In other words, Subpart F income includes most of the kinds of income on which disreputable offshore promoters tell you U.S. income tax can be deferred.

When a U.S. shareholder sells CFC stock, the gain is taxed as a dividend (i.e., as ordinary income) to the extent the CFC has previously untaxed and undistributed earnings and profits. Finally, the transfer of appreciated property by a U.S. person to a foreign corporation in exchange for the stock of the foreign corporation generally causes gain to be recognized even if the gain would not be recognized if the transfer were to a U.S. corporation. Thus, CFC status is usually something to be avoided.

OFFSHORE LLCS TAXED UNDER OTHER FOREIGN CORPORATION ANTI-DEFERRAL REGIMES

Even if a foreign entity classified as corporation for U.S. tax purposes is not treated as a CFC, there is a good chance it will be treated as a foreign personal holding company (FPHC) or as a passive foreign investment company (PFIC), which will cause tax results similar to those caused by CFC status for the typical U.S. owner of such a company. Foreign corporations also have certain foreign corporation information reporting requirements which can be burdensome. If these reporting requirements are not complied

with, substantial penalties and fines can result. Failing to elect passthrough tax treatment for a foreign eligible entity can be a disaster.

TAXATION OF OFFSHORE LLCS CLASSIFIED AS FOREIGN PARTNERSHIPS

The typical U.S.-owned foreign partnership is taxed generally like a domestic partnership. The former sections of the Internal Revenue Code which imposed a 35% excise tax on the contribution of assets to a foreign partnership (§§ 1491-1494) have been repealed. Now, all that is required is to make certain information reporting filings on Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, and related schedules (Form 8865, related schedules and instructions are included at the end of this outline). The reporting generally does not require any more information than the Form 1065, U.S. Partnership Return of Income, although the 8865 does ask for financial information conformed to U.S. Generally Accepted Accounting Principles (GAAP), which may require the partnership to convert some financial data to conform to GAAP.

Failure to comply with foreign partnership reporting requirements can result in the imposition of significant penalties, including the forced recognition of gain upon the transfer of appreciated property to a foreign partnership.

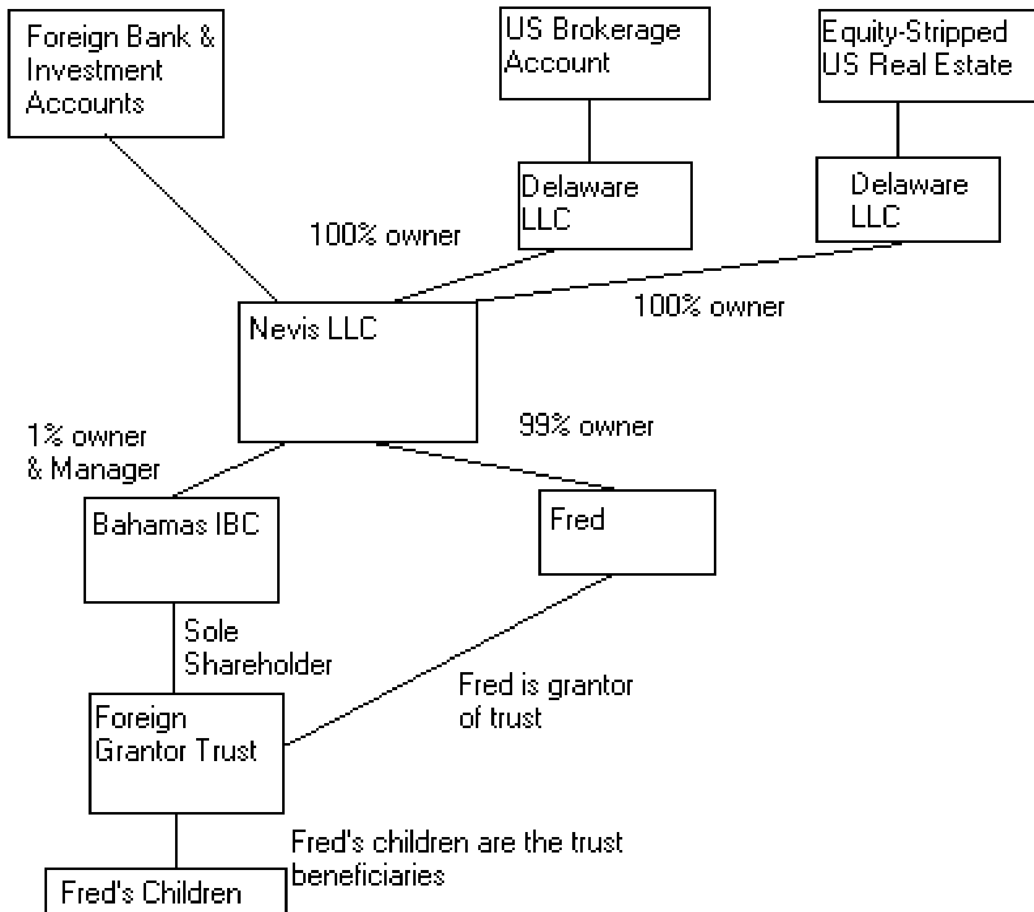
TAXATION OF FOREIGN DISREGARDED ENTITIES

Foreign disregarded entities are taxed as if the U.S. owner owned the assets of the entity directly. There are no reporting requirements regarding U.S. ownership of foreign disregarded entities. Apparently, some practitioners advise their clients to file Form 8865 to report activity involving foreign disregarded entities, but there are no statutory or regulatory requirements to do so.

Because there are no reporting requirements for U.S. persons owning an interest in a foreign disregarded entity, there is no risk of gain recognition on the transfer of assets to the entity or penalties for failure to report the type of information required from U.S. owners of foreign partnerships, foreign corporations and foreign trusts.

Recall the multi-member disregarded entity examples from above. Now consider the following example involving foreign entities; this structure will be considered to be owned entirely by Fred for income tax purposes.

EXAMPLE 5



LLCs & Estate Planning

LLCs, including Nevis LLCs, can be used as estate planning tools in the same manner as family limited partnerships. If the LLC is properly structured, LLC interests should be discounted for estate and gift tax purposes for lack of marketability and lack of control. In addition to the discounted transfer possibilities, LLCs are simply a convenient way to transfer assets to younger generations. There is no need to constantly re-title assets to reflect changing ownership; often transfer taxes on real estate, etc. can be avoided; ancillary probate can be avoided for real estate located outside the client's domicile, etc.

Until the end of the 1990s, limited partnerships were preferred over LLCs as estate planning vehicles because most LLC acts lagged behind limited partnership acts with regard to statutory provisions that were favorable for estate and gift tax discounting. However, many states have remedied the problem, with the result that LLCs are the favored vehicle in many states for estate planning.

In order to provide limited liability for the general partner of a family limited partnership, many practitioners form a corporation owned by the family matriarch and patriarch to act as general partner. Doing so of course, essentially converts the general partnership interests to corporate stock, with the adverse asset protection consequences that can bring.

An LLC can be used to act as the general partner without the adverse asset protection consequences of corporate stock. However, if an LLC is used as the estate planning vehicle itself, no separate general partner entity is needed, since there is not unlimited liability for LLC managers in the way that there is unlimited liability for general partners. Using an LLC also allows the estate planning vehicle to be formed as a single member entity with gifts made later, which can be useful if the children are not contributing assets upon the formation of the entity.

LLCs & Asset Protection Planning

There is an often overlooked but very important difference between being a shareholder of a corporation and a member of an LLC. The shares of a shareholder of a corporation are vulnerable to claims of the shareholder's judgment creditors. In many small businesses, this vulnerability could allow the creditor to control the business.

The membership interests of an LLC are more protected. In the U.S. and in offshore jurisdictions with U.S.-style LLC acts, a creditor of a partner in a partnership or a member of an LLC is entitled only to a "charging order," rather than being entitled to execute directly against partnership assets. A charging order gives a creditor the right to receive any distributions that the owner of the interest would have received. A charging

order is simply a court document that directs the manager(s) of the LLC to divert distributions that would otherwise go to the debtor member to the creditor to the extent of the unpaid judgment plus interest.

At first glance, the charging order may not seem like much protection. However, the economic rights to distributions are all that the creditor gets. The creditor does not get the management and voting rights that may go along with the LLC membership interest. The LLC's managers determine if and when distributions are made. It may be that distributions will not be made or that distributions will be significantly delayed. Some tax professionals believe that the creditor may be taxable on the debtor-member's income, even if the creditor never receives any distributions with respect to the charging order. This belief is suspect (see my article, "Tax Consequences of Charging Orders: Is the KO by K-1 KO'd by the Code?", Asset Protection Journal, Winter 1999, online at www.mayer-riser.com), but the uncertainty in this area can make a creditor contemplating a charging order very uneasy. Furthermore, it may be possible to draft an LLC operating agreement to push a charging creditor closer to being taxable.

The charging order is not an attractive remedy to most creditors. As a result, the prospect of a charging order can often convince a creditor to settle on more reasonable terms than might otherwise be possible. Shareholders of a corporation have little such leverage. Thus, in addition to being a very useful business tool, the LLC can be a valuable asset protection tool.

EXAMPLE 6

John and Jane have bounced back from the lemonade business debacle. Now they own two businesses. JJ Financial, LLC, which is owned 100% by John, is an investment advisory firm (John decided to change careers and passed all of his qualifying exams). JJ Antiques, Inc., which is owned 51% by John and 49% by Jane, operates a retail antique shop. John and Jane decided that the lawyer that helped them set up their LLCs in the past was too expensive, especially after paying everything to set up JJ Financial and get licensed. So, they formed the antiques corporation themselves using forms from their state's Secretary of State Web site.

One of John's investment clients was Dr. Smith, a wealthy retired physician with a $20 million portfolio. John had been analyzing the stock of ZZZ, Inc., which had been trading for about $10 per share. John believed it to be very undervalued and believed it worth about $30 per

share. He advised Dr. Smith to buy $1 million worth of ZZZ stock, forecasting that it would be worth $3 million on the market. A year later, other investors had caught on and ZZZ stock had doubled in value to $2 million. However, Dr. Smith wasn't satisfied, he wanted a triple return and sued John for the unrealized $1 million. John was particularly unpersonable at trial and the jury was unsympathetic, awarding over $1 million in damages to Dr. Smith.

When Dr. Smith's attorney began executing against John's assets on Dr. Smith's behalf, he found that John owned stock in JJ Antiques, Inc. and LLC membership interests in JJ Gas, LLC. Dr. Smith ended up owning John's stock in JJ Antiques, Inc., which he promptly liquidated since he was the majority stockholder. Dr. Smith also obtained a charging order against John's LLC membership interest. After a period of receiving no distributions, Dr. Smith decided to settle the outstanding liability for a reasonable sum.

THE CHARGING ORDER IS WELL-ENTRENCHED IN ANGLO-AMERICAN LAW

The charging order derives from American partnership law which derives from English partnership law. Under partnership law as it existed toward the end of the 19th century, a creditor of a partner could execute directly against partnership assets to recover the debt of a partner which was unrelated to partnership business. This proved very disruptive to partnership businesses, and was perceived as unfair because there was nothing non-debtor partners could do to prevent the disruption.

Around the end of the 19th century, the English Parliament drastically changed English partnership law with the enactment of the Partnership Act 1890. The Parliament decided that it was, in fact, unfair to disrupt partnership business by having the sheriff seize partnership assets and selling them to satisfy a debt unrelated to the partnership's business. The Act provided that rather than obtaining a writ of execution against partnership assets to satisfy a judgment debt of a partner, a creditor of a partner must satisfy a judgment by obtaining an order from a court charging the partner's economic interest in the partnership, i.e., his interest in partnership distributions of profits and capital.

When U.S. partnership law was being standardized in the early 20th century in the Uniform Partnership Act and later in the Uniform Limited Partnership Act, the charging order concept was imported into American partnership statutes. So, the charging order is well-established in the American law of partnerships and the concept now has been imported into American LLC law over the last few decades.

SINGLE-MEMBER LLCS AND CHARGING ORDERS

The single-member LLC is something of an anomaly since LLC law is largely based on the law of partnerships and, of course, there have never been single-member partnerships. There is nothing in any LLC act, foreign or domestic, that indicate that the charging order remedy is not the preferred or sole remedy available to a creditor of a member of a single-member LLC.

The original policy reason for the charging order, however, doesn't really exist with a single-member LLC. There is no other LLC member who would be unfairly affected by the seizure of LLC assets or of the LLC interest itself in its entirety.

It is the author's opinion that (1) a judge most likely would force a creditor of a member of a single-member LLC to pursue the charging order remedy before pursuing any other potential remedies; but that (2) judge's patience in waiting for distributions in satisfaction of the judgment should be expected to wear thin very quickly; and that (3) the threat of further judgment enforcement action beyond a charging order would always linger over the debtor-member of the single-member LLC. Additionally, because single-member LLCs are likely to have fewer records documenting LLC business matters, it is likely that a debtor-member of a single-member LLC will have a harder time defending a claim that the LLC is the alter ego of its owner, and should be ignored altogether, obviating the need for a charging order altogether.

Therefore, if asset protection via the charging order concept is a major concern, single-member LLCs should be used with caution. When possible an additional member should be included to bolster the charging order protection. An additional member often can be added without changing the tax treatment of the LLC, e.g., by using a grantor trust or another LLC or IBC.

CHARGING ORDER PROTECTION FOR MEMBERS OF FOREIGN LLCS

The members of a multi-member LLC should be well protected by the charging order in American courts. As noted above, the charging order has a long-established history in the U.S. Thus, even if a particular state's law required the application of its own LLC charging order law to the interest of a debtor member in an LLC formed under the law of another jurisdiction, the concept is neither alien nor out of line with the state's own public policy regarding the interest of a debtor member of an LLC. A debtor settlor of a foreign asset protection trust, on the other hand, will certainly be forced to wage battle against the long-standing public policy against self-settled spendthrift trusts in all U.S. jurisdictions except Alaska, Delaware, Rhode Island and Nevada.

FORECLOSURE

Many commentators and professionals – especially those with a vested interest in perpetuating the exclusive use of foreign asset protection trusts as primary asset protection vehicles – spend a great deal of time worrying about the possibility that a creditor with a charging order can foreclose on the charged LLC interest if the charging order is not quickly moving the creditor toward satisfaction of the judgment. The claim is often made that charging order protection is quickly being "eroded" by the increasing application of foreclosure by courts, implying that there is some great flood of foreclosure orders being issued.

In fact, there are only a handful of reported cases of foreclosure. Furthermore, even if a creditor does foreclose on the LLC interest, the creditor simply gets the LLC member's economic interest in perpetuity rather than for the length of time it takes to satisfy the judgment. As a practical matter, in asset protection litigation situations, those time periods can be about the same.

If a creditor were limited to the charging order, he might have to wait a very long time to get satisfaction. A creditor who has foreclosed will also likely have to wait a very long time to satisfy a judgment from LLC distributions, since the creditor is still in no position to force out distributions. A creditor to whom an LLC interest has been transferred in a foreclosure sale is still merely an economic assignee and does not succeed to the management and voting rights of the debtor-assignor. Another factor weighing heavily against a creditor initiating foreclosure is that while it is uncertain at best whether a creditor with a charging order is taxable on debtor member's share of LLC income, it is a near certainty that a creditor who has foreclosed upon a debtor's LLC interest will be taxable on the debtor member's share of LLC income. Finally, if the LLC manager is in a non-U.S. jurisdiction, the creditor assignee may be forced to pursue the manager in an inhospitable judicial arena, by which time the manager may have reorganized the LLC (potentially leaving the creditor with a significant tax bill and no LLC distributions with which to pay it), or otherwise made the funds practically inaccessible to the creditor.

The concern over the possibility of foreclosure drives the preference for the so-called "charging order exclusivity" provisions of some LLC acts. A few jurisdictions, Nevis included, provide that the charging order is the exclusive remedy by which a creditor of a member may satisfy a judgment from the debtor's interest in an LLC. It is unclear whether this exclusivity is meant to cut off the possibility of foreclosure or instead simply reinforces the idea that no judge should reach back to 19th century partnership law to issue writs of execution to the sheriff to seize LLC assets. It is the author's opinion that the latter is the actual legislative intent in U.S. partnership acts, which intent can probably be inferred

in those U.S. LLC acts which are derived from U.S. partnership acts, and which intent is quite clear in Section 18-703 of the recently amended Delaware LLC Act, which refers both to exclusivity of the charging order remedy and to foreclosure. However, the view that exclusivity language precludes foreclosure is so prevalent that it may actually have become the law in some jurisdictions; and probably is, in fact, the law in Nevis.

CHARGING ORDER LAW IN OFFSHORE LLC ACTS

Anguilla's LLC act provides for charging orders, but does not provide that the charging order is the exclusive remedy of a debtor of a member. Absent egregious circumstances, however, chances are probably slim that foreclosure would be quickly allowed, and chances are even slimmer that LLC assets would be reachable directly by the creditor of a member.

The Isle of Man's LLC act does not provide for charging orders by statute. Apparently the drafters of the Manx LLC act intended that LLC members would rely on Manx common law to provide charging order protection LLC membership interests.

The Nevis LLC Ordinance provides for charging order protection. It also provides that the charging order is the exclusive remedy of a debtor of a member. No mention of foreclosure is made in the Nevis LLC Ordinance. It seems clear that the intent of the Nevis LLC Ordinance is to eliminate the possibility of foreclosure in addition to eliminating the possibility that a creditor of a member could reach LLC assets directly.

FRAUDULENT TRANSFER ISSUES AND LLCS

The favorable position of an LLC member from the standpoint of a fraudulent transfer challenge is another reason to consider the LLCs as an asset protection tool. The fact that the exchange of property for LLC interests is a transaction for valuable consideration can make an asset protection structure based on an offshore LLC preferable to a structure that requires the gratuitous transfer of a large amount of assets, such as the foreign asset protection trust. This fact can also mean, in some circumstances, that LLC-based asset protection structures can be set up at times when foreign asset protection trusts cannot, although very careful "badges of fraud" and solvency analyses must be made first.

Transfers for which valuable consideration is received are difficult to challenge under the fraudulent transfer laws of most jurisdictions, which require proof of a transferor's fraudulent intent to set aside a transfer. Transfers of property in exchange for pro rata LLC interests are impossible to challenge as fraudulent in those jurisdictions which

require a showing that the transfer be without "equivalent value," regardless of the transferor's intent.

The use of offshore LLCs as asset protection tools has only become possible and practical in the last few years because of changes in U.S. tax law and the enactment of U.S.-style LLC legislation in Nevis. In the past, IBCs were popular asset protection tools (although their ultimate value as primary asset protection tools is questionable) to which for-value transfers could be made in exchange for IBC stock. However, the U.S. tax rules relating to gain recognition on contribution of appreciated assets to a CFC and the ongoing adverse income tax treatment made such planning painful from a tax standpoint. Some advisors tried to avoid the gain on contribution issue by having their clients first fund a foreign asset protection trust, followed by the trust forming and capitalizing an IBC, but this still left the client vulnerable to fraudulent transfer claims with respect to the transfer of the client's assets to the trust.

Both domestic and foreign LLCs share advantages over trusts with regard to fraudulent transfer claims. Foreign LLCs have some additional advantages over domestic LLCs that help the members of foreign LLCs avoid some of the more common creditor attacks on domestic entities.

A creditor of a member of a U.S. LLC with a U.S. manager may be able to obtain a court order forcing the manager to make distributions which, combined with a charging order, will satisfy the member's judgment debt. The creditor of a member of an offshore LLC with a non-U.S. manager (e.g., a Bahamas IBC) in most cases will not be able to obtain jurisdiction in the U.S. over the non-U.S. manager. Even if an order were issued by a U.S. court, the non-U.S. manager could not be forced to comply unless and until a successful action was brought in the non-U.S. manager's jurisdiction. The uncertainty surrounding the choice of law issues and the potential for success in a foreign jurisdiction create additional incentive for a creditor to settle on terms more favorable to the debtor LLC member than would otherwise be likely.

A creditor of a member of a U.S. LLC may also be able to obtain a court order dissolving the LLC, thus forcing out liquidation distributions which would, by virtue of a charging order, be diverted to the creditor to satisfy its judgment. A court in one U.S. state may or may not be able to order the dissolution of an LLC formed under the laws of another U.S. state, and if such an order was entered, it is unclear whether the courts of the state under whose laws the LLC was formed must give full faith and credit to the order.

These uncertainties do not exist with an offshore LLC. A U.S. court order purporting to dissolve a foreign LLC, such as a Nevis LLC, is not entitled to full faith and credit in the foreign jurisdiction.

CONDUCTING ACTIVE BUSINESS USING AN OFFSHORE LLC

Business owners conducting any type of business that has the potential for liability problems should consider using a an offshore LLC, with an offshore entity as manager, for its enhanced ability to provide limited liability protection to its owners for debts of the business to the extent that some assets of the LLC (e.g., working capital and equity stripped out of U.S.-situs property), can be held outside the U.S. in favorable jurisdictions that do not recognize U.S. judgments.

A judgment creditor of the LLC would be forced to bring an action, possibly even to re-try the case in its entirety, in each jurisdiction in which the assets were held in order to attempt to proceed against those assets. This would mean not only that the creditor would be forced to spend the time and money necessary to pursue these additional court actions, but also that the creditor would be forced to deal with foreign judicial systems, which may preclude punitive damages, forbid contingency fee arrangements for attorneys, and require the losing party to pay the legal fees of the winning party.

BASIC OFFSHORE LLC STRUCTURE

The structure in Example 5 above is one way in which a basic offshore LLC structure might be arranged. The Nevis LLC is the basic asset-holding entity. The U.S. client holds a 99% non-managing interest in the LLC. The other 1% interest is a managing interest and is held by a Bahamas IBC.

The shares of the Bahamas IBC are held by a foreign asset protection trust (e.g., a Nevis International Exempt Trust, or, if a lower profile is desired, an Isle of Man trust) settled by Fred and structured as a grantor trust for U.S. income tax purposes with the client's children (or anyone or anything else, but preferably not the settlor) as beneficiaries. The primary assets of the trust are the IBC shares and the primary asset held by the IBC is the 1% interest in the Nevis LLC. Thus, there is little chance of a fraudulent transfer problem with respect to a transfer to the trust.

Because the trust is a grantor trust and is the sole shareholder of the IBC, which along with the client are the only legal owners of LLC interests, the entire structure may be disregarded for U.S. income tax purposes by having the LLC and the IBC elect on Form 8832 to have each treated as a disregarded entity. Thus, there are no foreign information reporting requirements. If the client's spouse owns an LLC membership interest, the structure likely will be taxed as a partnership and the LLC would be required to comply with foreign partnership information reporting requirements by filing Form 8865.

If the client wishes to use the structure to hold U.S. real estate, the LLC might form a single-member Delaware LLC (since formation is inexpensive and simple, and Delaware

LLC law is very good) to take title to the property, with the equity being stripped out and the cash invested offshore. The Nevis LLC itself can hold foreign bank and investment accounts. The fact that the LLC is organized under non-U.S. law will make it easier to invest in foreign securities and mutual funds. However, extreme caution is advised with regard to the U.S. tax implications of foreign mutual fund ownership and the U.S. securities law implications of advising clients with regard to unregistered securities.

Note that if the Nevis LLC will be holding foreign stock, it may be best for the Nevis LLC to form an IBC (and to elect passthrough treatment for the IBC on Form 8832) so that the foreign securities are held by an corporation, rather than an LLC (the foreign inheritance tax treatment of which can be unclear), which should avoid any inheritance tax problems in the jurisdictions in which are domiciled the foreign corporations whose stock is held by the IBC. If a client wants to use a Nevis LLC to hold and protect U.S. investment accounts, such as an online brokerage account, another Delaware LLC might be formed to hold the account (since some brokerage firms might not be familiar with or comfortable with an offshore LLC owning an account).

If the client is faced with a large judgment, he will eventually have to disclose his ownership interest in the Nevis LLC to the judgment creditor. The creditor then has the option of seeking a charging order against that interest. At the time of disclosure, the client could simply offer to assign the LLC interest to the creditor in full or partial satisfaction of the judgment.

The creditor is now faced with an unenviable choice: (1) accept the voluntary transfer of the LLC interest knowing that he probably will be taxable on the debtor member's share of LLC income and will likely face a long court battle in the Bahamas and attempting to force the IBC, as manager of the LLC, to make distributions to him and attempting to prevent the IBC from diverting LLC funds elsewhere; or (2) pursue the charging order with the risk that (i) he will have little or no recourse to force the Bahamas IBC, as manager, to make distributions, and that (ii) he may be taxable on the debtor member's share of LLC income. Whether the creditor is ultimately taxable or not, the uncertainty may be reason enough for the LLC to send the creditor a Form 1065, Schedule K-1 every year purporting to show that he is taxable, and making the creditor's position that much more difficult.

The offer by the debtor member to voluntarily assign his LLC interest to the creditor should be looked upon favorably by a U.S. court. If the creditor declines the transfer, the debtor member can honestly say that he did everything within his legal ability to satisfy the creditor with respect to the LLC interest. If the creditor accepts the transfer, the debtor member can honestly say that he has rid himself of the LLC interest and has no

legal ability to do anything else with respect to it. The result of all of this should be that the creditor is pressured to settle for a reasonable amount.

Note that LLC-based planning does not preclude the use of foreign trusts. There is not an "either/or" choice between LLC-based planning and trust based planning. For example, one particularly strong structure might include the entities and trust described in Example 5 with the offshore LLC itself settling a "traditional" foreign asset protection trust. By having the LLC settle the trust, the fraudulent transfer risk might be shifted from the client to the LLC.

One particular advantage that LLC-based planning has is that it is very flexible, thanks in large part to the flexibility of the rules of partnership taxation, particularly the ability, in most cases, to deploy and redeploy assets without causing gain recognition. This allows LLC-based planning to be "modular." New entities and assets can be easily added to a structure in ways that make sense from a business point of view.

COSTS

Generally, the costs involved in setting up an offshore LLC structure with an offshore LLC asset-holding entity, a foreign corporate management entity, and foreign trust will be comparable to (and sometimes slightly less than) the typical costs involved in establishing a typical foreign asset protection trust structure. Costs will, of course, vary depending on the complexity of the structure (ancillary entities, trust(s), investment accounts, etc.) and the nature of the assets to be held in the structure. The ongoing administrative costs (filing fees, registered agent fees, tax return preparation, etc.) associated with offshore LLCs tend to be slightly higher than comparable costs for domestic LLCs. Those costs will be higher if the LLC is treated as a partnership rather than a disregarded entity so that Form 8865 must be filed.

In evaluating costs, keep in mind that the protection offered by this type of structure is dependent not on the mere existence of the structure, but rather on the careful drafting of the associated documents, which requires a U.S. attorney experienced in such matters. Furthermore, planners practicing in this area take on a considerable amount of risk and must spend a very considerable amount of time researching domestic and foreign law as well as domestic and foreign service providers. Thus, planners must price their services accordingly. Advisors practicing in the area should be well-insured and advisors referring clients to such planners, should enquire as to the potential planner's professional liability insurance coverage (or lack thereof).