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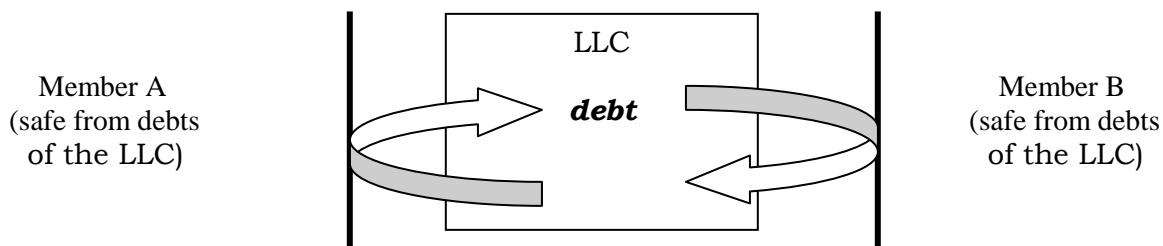
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Explanation of Limited Liability Companies

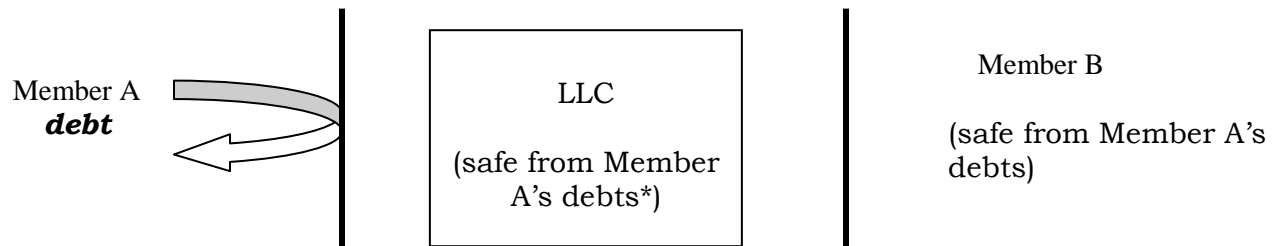
The use of limited liability companies (LLCs) is a highly effective way to protect your personal assets from debts and other liabilities arising from the business properties. It is also the most effective way to insulate an investment property from the debts of another investment property. Ultimately, the best asset protection plan is to hold *each* property and *each* business in its own LLC, while a less complex alternative would be to form several LLCs and group selected properties in each based on risk, value, location or any other factors that make sense in the overall organization of your business.

An LLC is a business entity created by Massachusetts statute that limits the liability of every member (a “member” is like a shareholder or a partner) for debts of the LLC. The only assets at risk are those assets invested in the LLC. Personal assets beyond that investment are not generally at risk, but please be aware that this limited liability assumes you are maintaining a certain respect for the business – treating it like a business and not like your personal assets.

Protection from “Inside” Debts: A creditor of the LLC generally cannot reach through the entity to the personal assets of the members, but instead is limited to the assets of the LLC to satisfy its claims.



Protection from “Outside” Debts: An LLC also offers the “reverse” protection, meaning that the LLC’s assets cannot be used to satisfy the debt of a member. A personal creditor (unrelated to the business properties in the LLC) is not able to reach assets in the LLC(s) *assuming there is more than one member of the LLC*. If there is only one member, then there are additional issues to be discussed, but one-member LLCs are generally not recommended if the primary goal of the LLC is to provide asset protection.



*assumes there is more than one member of the LLC

Creditor’s Charging Order Remedy: Note the difference between an LLC and a corporation. The creditors of a shareholder of a corporation can attach the shares owned by the debtor/shareholder and actually *become* a shareholder – taking on the same rights that the debtor had with regard to those shares, such as voting rights, redemption rights and the like. On the other hand, the creditor of a member in an LLC cannot take over a membership interest and become a member of that LLC. Instead, a creditor’s right to seek payment from an LLC interest is limited to what is called a “charging order”. A charging order grants the creditor the right to receive income or liquidation distributions from the LLC, but only if and when the LLC makes the distributions. Even if the membership interest held a voting power, the creditor cannot exercise that vote or participate in management of the LLC in any way. The next course of action becomes a holdback of all distributions (to the extent it can be justified for business purposes) to persuade the creditor to settle for less money instead of waiting indefinitely for payment. Obviously there are limits to how long the managing members of the LLC can hold back distributions; however, there are many legitimate business reasons to withhold distributions or to make only limited distributions to members.

Insulating Several Properties with LLCs: The use of multiple LLCs will enable you to insulate each property from the debts and liabilities of the others. For example, assume there is an accident on the Property A, and the injured person wins a substantial judgment. Any of the properties held by the same owner as Property A can be attached to satisfy that judgment, including your personal property. So, if Jane holds Property A in her own name, then any asset in which Jane owns an interest is at risk should there be a substantial judgment. If Property A is held in LLC A with no other assets, then the injured plaintiff's judgment can only be executed against the property owned by LLC A, which ideally would be the property itself, insurance proceeds, and only a small operating account. All other properties not held by LLC A, including personal assets and assets in LLC B, are protected from that risk. If you were to set up an LLC for each of your properties, then each will be insulated from the debts of the other, and personal assets will be insulated from the debts of all of them.

Operating Agreements: Operating agreements are strongly recommended for each LLC. If you choose not to have operating agreements for your LLCs, then the operation of the entity is governed by Chapter 156C of the Massachusetts General Laws. Operating agreements become particularly important when gifts of LLC interests are made to the children as part of a business succession and estate tax savings plan. If a business owner should choose to include the children as members of an LLC, then that owner would certainly want an operating agreement to protect the family investments from outside interference, such as from spouses, creditors, etc. It is not uncommon for people to rely on the statute for operating their LLCs, but here are just some of the benefits of an operating agreement can provide:

- Operating agreements can include buy-sell agreements to govern what happens to a membership interest when, for example, a member wants to leave the business, goes bankrupt or is otherwise subject to collection actions (including a property division in a divorce) or dies or becomes incapacitated and cannot manage his or her own assets.
- Operating agreements contain provisions for preventing unwanted members and for accepting new members. For example, who will be accepted as a member automatically? Will heirs automatically become members or will there have to be a vote? If a vote is necessary, what number of votes is needed to admit them as members?

- Provisions to enable gifting for estate and gift tax planning and general business succession planning. There are a lot of benefits that an LLC can provide to facilitate the transfer of the business to the younger generations and to do so in the most efficient manner for estate tax planning purposes.
- Ability to create voting and non-voting LLC membership interests and to define the extent of control each type of interest will have. This enables you to engage in succession planning with your children because you can transfer non-voting interests to younger generations to start moving the business and getting them involved, without losing control of the business to them before you are ready to do so.
- Method for flushing out any misunderstandings before they become problems – the process of preparing the agreement causes the members to consider and discuss some “what ifs” and reach an agreement as to how situations will be handled if they should ever happen – best done at a time when there is no brewing dispute.
- Management and other provisions that meet your intentions, as they relate to your business.

Buy-Sell Agreement: A “buy-sell agreement” is an agreement among the LLC members that sets out the remaining members’ rights to buy an exiting member’s interests for a fair price. It can cover any conceivable situation – death, illness, incapacity, irreconcilable disputes, property disputes in divorce, etc. As noted above, a buy-sell agreement is often incorporated into an operating agreement.

For example, you can have an agreement for each LLC that you form whereby the death of a member would result in the surviving member(s) having the right to purchase the deceased member’s interest from the estate for a fair price. The beneficiaries of the deceased member’s estate would receive the purchase price in cash or promissory notes instead of sharing in the business properties. The agreement can even include an agreed upon method for determining the price and settling disputes with the deceased member’s heirs if they cannot agree on the price.

Gifts of LLC Interests: Beyond asset protection, LLCs make it much easier to transfer business assets to the next generations in an orderly way, while also offering estate and gift tax savings. A detailed discussion of succession methods and the estate and gift tax advantages is beyond the scope of this article, but briefly note that gifts of non-controlling interests can be made to younger generations for succession, tax and asset protection planning purposes.

Capital Gains Taxes: There is no capital gains tax on the transfer of an investment property to an LLC. Your *future* capital gains tax obligations will be calculated using the basis in the property at the time you transferred it into the LLC – a carryover basis – as adjusted for depreciated deductions and capital improvements, but usually only when you sell a property. There are other issues related to basis and calculation of capital gains that are also beyond the scope of this letter. The most important thing to note is that you are not triggering a capital gains tax by transferring real estate or other capital assets into an LLC.

Risk to Liability Protection: There is always a possibility that an LLC would not afford the anticipated liability protection *if* the members do not comply with the formalities for operating an LLC. For example, if you use assets of the LLC as if they were your own, with no deference to the business, then a creditor can argue that it is an LLC in name only. You have to treat your LLC like a business to ensure that your creditors are forced to treat it as a business as well. The term “piecing the veil” is used to describe an attack on an LLC based on the members’ failure to treat it like a legitimate business, and it refers to a creditor’s claim that the LLC was a sham to thwart creditors and not a legitimate business entity.

The easiest examples of not maintaining the entity properly would be not registering the LLC with the Secretary of the Commonwealth, not paying the annual fee and filing the annual report, commingling your own personal assets with the LLC’s assets, not maintaining a separate set of books and accounts for the LLC (which inherently leads to commingling personal and LLC assets), etc. It is not difficult to maintain these formalities once they are in place, but it is crucial to ensure your planning goals.

Taxation of your LLC: An LLC can be taxed as a corporation or as a partnership, with the usual method being a partnership. When taxed like a partnership, an LLC is a “pass through” entity, which means that all of the income tax attributes pass through to the members and are reported on the members’ income tax returns. An LLC does have to file an income tax return each year reporting the income and deductions and identifying the members that are allocated those items; however, there is no separate income tax for the LLC to pay.

Documentation for the LLC: The following documents are recommended to form and properly operate each LLC:

- Operating agreement with buy-sell agreement built-in
- Certificate of Formation and fee of \$500 to the Commonwealth of MA
- Deeds for properties being moved into new LLCs
- Annual Reports and annual fee of \$500 to the Commonwealth of MA
- LLC record book
- Form SS-4 (to obtain a tax identification number for new LLCs)