LEE R. PHILLIPS

TOOLS OF WEALTH

USING THE LAW TO MAKE MONEY

SEVEN

LEE PHILLIPS SHARES THE LEGAL TOOLS OF WEALTH WITH YOU

LLCS—GREAT TOOLS TO USE

By Lee R. Phillips, JD

Limited liability companies (LLCs) are one of the best asset protection tools and tax planning tools we have today. They are better than a family limited partnership (actually, a limited partnership of any type), because they do not have an exposed person, i.e., the general partner. LLCs also have significant tax advantages over any other entity, because the owners can decide what "entity structure" they want to be taxed as. Additionally, distributions (shares of profit or loss) do not have to be allocated among the owners on a "pro rata" basis. That means if four people each own 25% of the LLC, the profit can be directed, independent of the ownership, to any one or more of the owners in any percentage the managers (directors) decide.

LLCs don't require as much "maintenance" as a corporate structure, and yet they offer the same degree of asset protection. I prefer LLCs over land trusts, because they give you actual asset protection, whereas the land trusts only offer you a very minimal amount of "anonymity." However, the LLCs have to be registered with the state, and an annual fee has to be paid. Land trusts don't have state fees associated with them, because they are not registered. In many states the LLC fees are minimal, on the order of $50 to $150, but in some states the fees are close to a $1000 per year. Not to mention any names, but if you live in California, you are basically going to pay through the nose. New York residents will pay several thousand dollars to establish an LLC, but the annual fees are at least cheaper than California.

An LLC can be taxed as basically any entity that you choose (sole proprietor, partnership, corporation C or S). It is a "check the box" with the IRS. If you have multiple members (owners) you will be taxed as a partnership or corporation (C or S). If you are the sole owner of the entity (single member LLC) you can choose to be taxed as a sole proprietor or corporation (C or S). If you are being taxed as a C corporation, your

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GOT QUESTIONS?

What are your needs, concerns, or challenges?

Email Lee with questions you would like to see answered in this newsletter.

Email: info@legalees.com

KRISTY'S KORNER

By Kristy S. Phillips, JD

You do not need to be afraid to take control of your legal affairs. In fact, it would be a mistake for you not to take control. Yesterday a business friend of mine, who I'll call Stan Smith, brought his old trust in for updating. He is now retired, but he was one of the biggest retailers in our community. His wife, Suzy, was an English professor at one of the nation's largest private universities. They are bright informed people and they had set up a living trust years ago.

Their trust was unbelievable. It had been drawn by another attorney, and as I read through the document, I was stunned at the mistakes. It made me think how important it is to look over your documents and not blindly trust your attorney. In this trust, there were some really obvious mistakes, mistakes that an English professor and a businessman should have picked up. For instance, under the section Trustor's Family it read, "The Trustor's wife is Stan Smith." The attorney made a big whoops! Obviously the Trustor is Stan and his wife is Suzy Smith.

Stan and I discussed what he wanted to give to his children. He didn't want to change anything, so we read the trust. Stan had a daughter by a previous marriage who he wanted to provide for, but he only wanted to give her about one fourth as much as the children he raised. I guess the attorney

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accountant better have a compelling reason for you to be taxed as a C corporation. It isn't a legal issue. It is an accounting issue. C corporations very rarely give you any advantage, and they often have severe disadvantages. In 95% of the cases, you will want to be an S not a C corporation. If you do choose to be taxed as a corporation, you will need to get a tax identification number (EIN – employer identification number).

If you are willing to be taxed as a "sole proprietorship," then you don't need to get an EIN. You will still operate as an LLC, but it will be a "disregarded entity" in the eyes of the IRS. For tax purposes you will file a Schedule C on your 1040 return, just as if you were a sole proprietor. However, you will have the liability shield of the LLC. The form of taxation has nothing to do with the liability shielding. So for a single member LLC, the taxes are easy and you get the liability shield.

If you are a single member LLC, why would you want to be taxed as an S corporation? The main reason is because you can take distributions out of the S corporation, and the distributions are not subject to FICA, self employment, and other taxes. Sorry, you still have to pay income taxes on all the money, but on the distributions you will save about 6 – 8% on the taxes. However, be aware that you have to take a "reasonable salary" before you start dishing out distributions.

Some of my students are starting to ask me about series LLCs. Seven states (Delaware, Iowa, Illinois, Nevada, Oklahoma, Tennessee, and Utah) have tried to help out their citizens by passing laws that permit what is called a "series LLC." A series LLC is basically a master LLC with a series of baby LLCs attached to it. Each "series" is regarded as a separate entity for asset protection purposes, but the state only sees the master LLC for its fee structure. The master LLC is often called an umbrella LLC and the baby LLCs or series are called cells. Only the master LLC pays the state formation fees and maintenance fees.

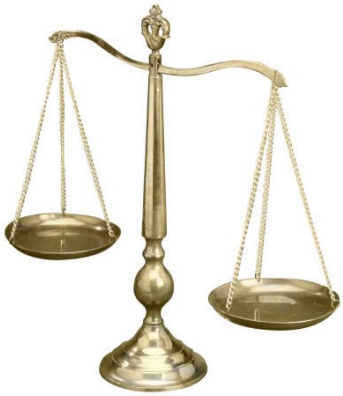
This is a great idea for the real estate investor who has a number of units and would like to get separate asset protection for each one of the units. The investor simply sets up a master LLC and then puts each property in a different cell under the master. Thus, you get one fee and multiple "legal pockets" or cells that are separated, as far as the asset protection issues are concerned. That is a ton better than the land trusts or paying fees for every LLC.

Each of the series LLCs needs to keep its own financial records and have separate bank accounts, but they usually do not have to file separate tax returns. Each cell LLC should do its own "business." When it does business with the master or another cell, it should conduct the business at arm's length. Money obviously shouldn't be comingled. These are separate businesses, and they have to be treated as separate businesses. The courts won't treat them as separate businesses or cells if you don't.

Most states will "honor" a series set up under one of the seven states' laws. So if you have your properties in Indiana, you can probably use an Illinois series and have each Indiana property owned by a different cell LLC. Indiana will treat them as one taxing unit, and only one fee needs to be paid to Indiana, if the master LLC has to register in Indiana. California is the only state which has specifically passed laws saying that each cell LLC has to pay its own California fees and pay its own California taxes. (Welcome to the Republic of California.)

Having said all that, it is very uncertain whether or not the different series cells will be treated as separate entities for asset protection purposes in a state that doesn't have the series LLC laws. For that reason, it may be prudent to actually create separate LLCs in Indiana, for example, and have each registered with the state. Bottom line is, there is a substantial risk of having the different cells in the series lumped together for asset protection purposes in a state that doesn't have specific series LLC laws. So when the guy in Nevada tries to "up sell" you to the series LLC package, and your properties are all in Georgia, you probably shouldn't go for the series package. (In my opinion, you shouldn't be incorporating in Nevada for most purposes anyway.)

The IRS is just developing their rules that will apply to series LLCs. Basically, each series or cell is looked at independently to see if it will be considered a disregarded (ignored) entity in the eyes of the IRS. If the ownership of the master and the cells is exactly the same, then the IRS will ignore the cells and



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only one tax return is required. Everything will "feed up" from the cells to the master LLC for tax purposes. However, if the master is owned by you, for example, and then the cells are owned by you with other "partners" or owners, the IRS will consider each cell a different taxing unit. It is easy to add a new owner in one of the cells. All you have to do is amend the operating agreement to reflect the new owner.

To add another cell, all you have to do is amend the operating agreement for the master LLC and show the new name. You should register the name with the state or county to protect the name and give notice to the public that the name is being used as the name the cell is doing business under.

When you take title to property or do business in one of the cells, make sure the cell is specifically identified as a separate unit. For example, with a master LLC named John Doe Properties LLC, the checking account for the new cell or series would read "John Doe Properties LLC, Series Green Apartments only."

LLCs are great tools. They have been around long enough that the kinks have been worked out of them, so don't let any attorney tell you they are "new" and you shouldn't use them. What the attorney is really saying is, "I was only trained on corporations, so let's do a corporation." The series LLCs are new, and there are still a lot of "what ifs" that haven't been answered. If you are doing business in one of the states that has already approved series LLCs, by all means start using them. If you are in another state (other than California) and want to try and use a "foreign series LLC" in your state, it is going to be better than a land trust for asset protection, but know you are in uncharted waters.

Write me with your LLC questions, and I can help. LLCs are great tools. When you master their use, you'll get more money and enjoy a lot more asset protection.■

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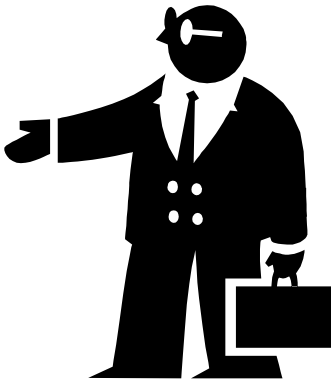
KRISTY'S KORNER, CONT.

couldn't figure out how to do it, so he wrote the trust to disinherit her. Stan also had two special needs grandchildren who he wanted to help provide a little extra for. The attorney provided for them as long as their parent was living. If the parent was dead, they did not get any help. Does that make sense?

These obvious mistakes were not legal issues. By just reading your trust, you should be able to "pick up" these types of mistakes without any special legal knowledge. The Smiths were horrified that they had not seen the mistakes. They had blindly trusted their attorney and now they shuddered as they contemplated what would have happened if they had died. Yes, there were the simple mistakes, and there were also a lot of "legal mistakes." I think it is fair to say that if your trust has the simple mistakes, it also has legal mistakes.

I didn't go into a deep discussion of the legal problems, because they weren't students of the *Accumulation and Preservation of Wealth* course. They were given a Qualified Terminable Interest Property Trust, or "QTIP Trust." A QTIP trust is a special marital deduction trust that limits the surviving spouse's access to and control over the trust property. It is "qualified" to take advantage of the state and federal estate tax marital deduction laws. A QTIP trust is used when there are serious concerns about a surviving spouse remarrying and thereby causing the heirs to lose property to the new guy or new girl. It can also be used if the surviving spouse has creditor problems and there is a chance that creditors would try to take property away from the surviving spouse.

Actually, if the Smiths had listened to the *Accumulation and Preservation of Wealth* course CD 7, they probably would have realized that they didn't really want a QTIP trust. They also would have realized that their attorney only included one of the three IRS required elements that a QTIP trust must have. The attorney had thrown in some "legal language" to confuse the issues. The legal language contradicted itself and other parts of the trust. If Stan and his wife had died, their family would have had to go to court to clear up the contradictions. The Smiths are bright people. They just didn't take charge of their affairs. In today's troubled times, none of us can afford to make these mistakes. ■



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USING THE LAW TO MAKE MONEY

NEW LLC PACKAGE

Because LLCs are such great tools, I have prepared an extensive LLC set to compliment the *Accumulation and Preservation of Wealth* materials. It is six CD sections (about one hour each) with all of the supporting workbook materials. It walks you through step by step how to set up an LLC in your state, how to establish a unique operating agreement, how to maintain the LLC, what tax tricks are available to your LLC, how to shore up the asset protection value of the LLC, when you can use a series LLC, and all of the nuts and bolts that into an LLC. More information is found at http://www.legalees.com. Or just call the order line at 800-806-1998.■