AUTUMN 2000 • VOLUME 2 • NUMBER 3

ASSET PROTECTION JOURNAL

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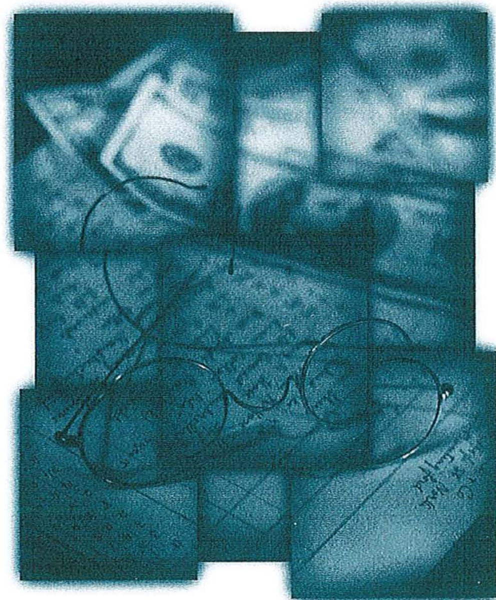

A PANEL PUBLICATION
ASPEN PUBLISHERS, INC.

Comparison of the FLP versus the LLC as a Complement to the Foreign Asset Protection Trust

By MARK MERRIC

Integrated estate planning combines both asset protection planning and estate tax planning. Many times, the planner will combine a domestic family limited partnership (hereinafter referred to as "FLP") with a foreign integrated estate planning trust (hereinafter referred to as a foreign "IEPT"). This article contrasts utilizing a single member (non-entity) limited liability company[1] (hereinafter referred to as the "single member LLC") instead of the traditional FLP in combination with a model foreign IEPT structure.

BACKGROUND

With the typical foreign IEPT structure, the FLP is added to the structure so that the client, as general partner of the FLP, will have direct control over all of the assets owned by the FLP. The diagram on page 32 (Figure 1) depicts a typical *single* settlor IEPT structure.

A "typical" *single* settlor foreign IEPT structure has one settlor, who is also the sole general partner of the FLP. After the client creates both a foreign IEPT and a domestic FLP, the client gifts a 99 percent limited partnership interest to the foreign IEPT, and the client retains the one percent general partner interest. Most of the client's assets are transferred into the family limited partnership, including almost all liquid assets.[2] Assets that have special tax concerns if owned by the FLP, such as subchapter S stock, annuities, and the personal residence, are transferred directly into the foreign IEPT.[3] The result is that most of a client's liquid assets are owned by the FLP, and the client as the general partner has direct control over all of these assets. Therefore, the client may make any investment decisions over these assets without obtaining any trustee approval or incurring any trustee expenses.

In contrast to the typical single settlor foreign IEPT structure, many times a husband and wife will create a two-settlor foreign IEPT structure. A diagram of a typical two-settlor foreign IEPT structure is depicted as follows (Figure 2).

In a typical two-settlor foreign IEPT, both the husband and wife will be one-half of one percent general partners, and the foreign IEPT will have a husband account and a wife account. The primary reason why most clients choose to create a two-settlor structure rather than a single settlor structure is to minimize the annual trustee and accounting fees.[4]

PROBLEMS WITH UTILIZING THE FLP

Although the FLP combined with the foreign IEPT gives the client direct control

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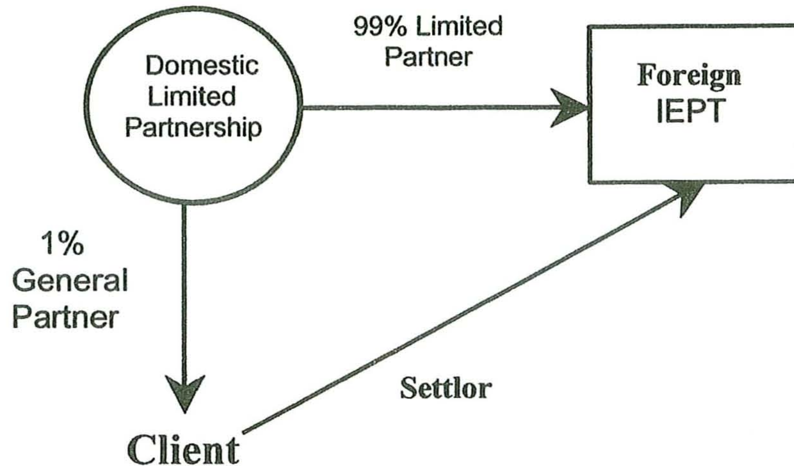
In contrast to the typical single settlor foreign IEPT structure, many times a husband and wife will create a two-settlor foreign IEPT structure.

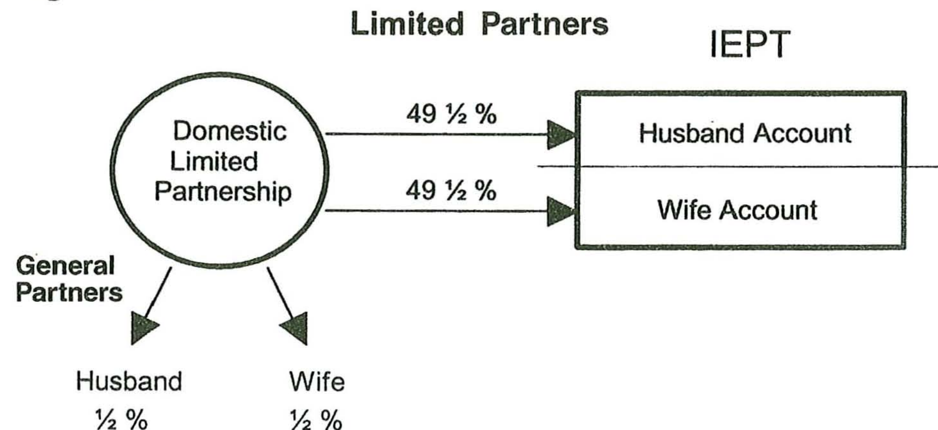
Figure 1.
Typical Integrated Estate Planning Structure



over most of the assets owned by the foreign IEPT structure, the following problems must be considered.

1. The transfer of separate property into a FLP in a two-settlor foreign IEPT structure may be deemed a gift from one spouse to the other and be considered non-marital property in the event there is a divorce.
2. The transfer of marketable securities by husband and wife into a dual settlor structure may result in gain under the investment company pitfall of §721(b).
3. When property subject to a debt is contributed to an FLP, the deemed distribution of money under IRC §752(b) may result in gain recognition under IRC §731(a).
4. The distribution of marketable securities under IRC §731(c) may trigger taxable gain to the extent the deemed money distributed exceeds a partner's adjusted basis.
5. The grantor trust may not be respected as a second partner.
6. In the event of a legal crisis, one percent of the client's assets would be available to creditors.
7. Many clients do not administratively respect the one percent to 99 percent split in regard to contributions to and distributions from the FLP. This could be one of the factors a

Figure 2.



court may rely on to find that the partnership was a sham, or the agent, or alter ego of the partners.

Divorce

Under most state laws, when one spouse gifts property to another spouse, the gifted property is *not* considered marital property in the event of a divorce. After the gift, the gifted property becomes the separate property of the spouse receiving the gift. Therefore, in the event of divorce, the spouse receiving the gift often gets to keep the entire property, and the spouse giving the property gets nothing.

In a two-settlor foreign IEPT structure, both the husband's and the wife's account each own a 49.5 percent interest in the FLP. Let us assume that the husband transfers $1 million of his own separate property to the FLP. A divorce court may conclude that he made a gift of 49.5 percent to the wife's account. If the court finds that a gift was made, the wife would be entitled to keep approximately one-half of the value of the FLP. To the extent of the gifted property, it would not be considered marital property eligible for division. Whereas some clients may wish to make a large gift of separate property to a spouse, most clients that have accumulated large amounts of wealth outside the marriage do not. Unfortunately, when creating a typical two-settlor foreign IEPT, many clients are not fully advised regarding the possible consequences of transferring separate property to an FLP.

It should be noted that this conversion of marital property to separate property problem exists whether a single FLP or a single, single member LLC is used in combination with the foreign IEPT structure. In a dual settlor structure with one entity (either the FLP or the single member LLC), anytime separate property is contributed into the entity, to the extent the other spouse's interest increases in such property, there may be a gift for domestic relations purposes. In this sense, neither the FLP nor the single member LLC has an advantage over the other. Because there is a misconception that the single member LLC solves the conversion of marital property to separate property problem, however, this issue is discussed in this article.

A simple solution to avoid the possible unintentional gift of separate property is to create two FLPs or two single member LLCs, one for the husband and one for the wife, in combination with the two-settlor foreign IEPT. A diagram of this structure is detailed in Figure 3.

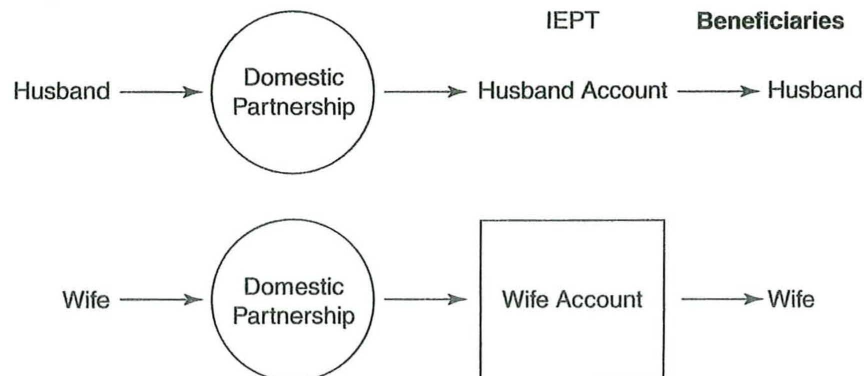
Under this arrangement, the husband contributes his property to his own FLP, and the wife contributes her property to her own FLP. The husband's account owns a 99 percent limited partnership interest in his FLP, and the wife's account owns a 99 percent limited partnership interest in her FLP. In the event marital property is to be contributed to the structure, a third FLP or single member LLC should be created.

A more complex solution to the separate property issue, but one that is stronger for asset protection purposes, is not to use a two-settlor foreign IEPT. Instead, two *single settlor* foreign IEPT structures should be created, one for the husband and one for the wife. By creating two separate single foreign IEPT structures, the trustees of the foreign IEPTs will not be stifled from acting in the event of a divorce.[5]

Investment Company Pitfall Under IRC §721(b) and §351(e)

The investment company pitfall under IRC §721(b) occurs when (1) marketable securities[6] are transferred to a partnership by a partner; (2) as a result of the transfer there is a diversification of the marketable securities;[7] and (3) after the transfer, marketable securities represent more than 80 percent of the fair market value of the FLP.[8] When a husband and wife each transfer *nonidentical* marketable securities to a partnership, generally, the transfer results in a diversification of both of their interests.[9] For example, if a husband transfers

Figure 3.



Microsoft stock worth $2 million (adjusted basis $500,000) and the wife transfers Bausch & Lomb stock worth $500,000 (adjusted basis $100,000) to the FLP, after the transfer, each owns an undivided interest in one-half of both the Microsoft and Bausch & Lomb stock. Since Microsoft and Bausch & Lomb are both stocks traded on a public exchange, the first requirement is met. The second, the diversification requirement is also met, because both husband and wife own each indirectly through the FLP own interests in stock they previously did not own. Finally, assuming these are the only assets transferred to the FLP, more than 80 percent of the FLP is comprised of marketable securities, and therefore, this requirement is met. The result is that all three requirements are met and gain is recognized as the difference between the fair market value of the marketable securities transferred and their respective adjusted basis. In this example, the husband would recognize $1,500,000 of gain and the wife $400,000 of gain. This recognition of gain is referred to as the investment company pitfall under IRC §721(b) and §351(e).

The possibility of falling into the investment company pitfall creates a burdensome task for the planner. In order to prevent possibly falling into the trap, the planner must determine the assets that are being contributed by each spouse, their respective fair market value and adjusted basis, and then determine whether the investment company pitfall applies. This cumbersome task must be performed for each single FLP that is combined with a two-settlor foreign IEPT structure.

Although there are several methods of avoiding the investment company pitfall,[10] one method is to create two FLPs, one for the husband and one for the wife, in combination with a dual settlor IEPT. This is the same solution that was proposed previously for remedying the conversion of separate property to marital property issue of divorce. Another solution is to use *one* single member LLC, rather than an FLP. As a non-entity, the LLC would completely be ignored for tax purposes. The assets of the LLC would be taxed as if they were owned directly by the foreign IEPT. Because the investment company pitfall only applies to a partnership or a corporation, it would not be an issue in regard to a single member LLC.

Net Debt Relief Greater Than Basis Issue Under IRC §731(a)(1)

What if the husband owns real estate with a fair market value of $500,000 with an adjusted basis of $50,000, which is subject to a recourse note in the amount of $300,000. The real estate subject to the mortgage is contributed to a single FLP combined with a two-settlor IEPT structure. Prior to the contribution, the real estate was titled only in the husband's name and only the husband was liable on the mortgage. Although it is not important for the purpose of this

example, assume that his wife contributes $500,000 worth of marketable securities.

When a partner contributes property subject to a debt, gain is recognized to the extent of any *deemed* money received from a partnership greater than the partner's adjusted basis in his partnership interest.[11] Any decrease in a partner's share of individual liabilities is treated as a deemed distribution of money.[12] Therefore, when the partnership received the property subject to the mortgage, there was a deemed distribution of money to the husband in the amount of $300,000. Also, any increase of a partner's share of partnership liabilities is treated as deemed contribution of money. Therefore, the partnership's act of taking the property subject to the debt increases the partnership debt by $300,000 and to the extent of the husband's 50 percent interest, there is a deemed contribution of money for $150,000. Therefore, under this example, the husband would recognize gain on the contribution of the real estate to the FLP in the amount of $100,000 computed as follows.

Decrease in husband's individual liabilities IRC § 752(b) (Relief of Debt)	$300,000
Increase in husband's partnership liabilities IRC § 752(a) ($150 × 50% interest)	150,000
Deemed Money Received	150,000
Adjusted Basis of Partnership Interest	50,000
Gain Recognized Under IRC § 731(a)(1)	**$100,000**

It should be noted that the net debt relief greater than basis issue is generally encountered in a single entity FLP combined with a two-settlor foreign IEPT. It is also possible to encounter the net debt relief greater than basis issue in a typical single settlor foreign IEPT structure.[13] Similar to the investment company pitfall of IRC§721(b), the net debt relief greater than basis issues is strictly a problem of being taxed under the partnership rules of taxation, and may be totally avoided by utilizing a single member LLC.

Distribution of Marketable Securities Issue Under IRC §731(c)

Typically, when the legal waters become rough, the foreign trustee of a foreign IEPT begins to take protective measures. One of these protective measures is to dissolve the domestic FLP. When the domestic FLP is dissolved, 99 percent of the assets owned by the FLP will be transferred directly to the foreign IEPT. Under IRC §731(c), when marketable securities are distributed to a partner, they are to be treated as money for purposes of determining whether gain is recognized under IRC §731(a). As noted previously, gain is recognized anytime a deemed distribution of money exceeds the partner's adjusted basis. Therefore, the foreign IEPT will be deemed to have received a distribution of money computed as the sum of the fair market value of the marketable securities plus the amount of cash distributed. If the foreign IEPT's adjusted basis is less than the amount of money distributed and one of the exceptions does not apply, gain will be recognized at the time the protective measures are taken by the foreign trustee.

In the case of a single settlor foreign IEPT structure, IRC §731(c)(3)(B) provides an exception that will almost always apply. Therefore, in almost all cases, the possibility of gain recognition due to the distribution of marketable securities is not an issue. The result, however, may be quite different in the case of a two-settlor foreign IEPT structure.

Assume that the husband contributes marketable securities in a brokerage account with a fair market value and an adjusted basis of $200,000 to the FLP. The wife contributes land worth $200,000 and it has an adjusted basis of $50,000. Three years later, the marketable securities have increased to $300,000. At that time, the legal waters become rough and the foreign

trustee as majority interest partner in the FLP decides to liquidate the FLP. Ninety-nine percent of the assets are distributed to the two-settlor foreign IEPT (49.5 percent to each respective husband and wife account). A foreign IEPT is classified as a grantor trust for income tax purposes, and is therefore disregarded as an entity.[14] Therefore, the distribution to the respective accounts of the IEPT is taxed as if the distribution was directly to the husband and wife.

As illogical as it seems, based on the aforementioned facts, the wife will recognize gain under IRC §731(a) and (c) in the amount of $50,000 computed as follows.

Marketable Securities IRC § 731(c) ($300,000 × 50%)	$150,000
IRC § 731(c)(3)(B) Adjustment ($300,000 − $200,000) × 50%)	(50,000)
Amount of money deemed distributed under IRC § 731(c)	100,000
Wife's basis in her partnership interest	50,000
Gain Recognized Under IRC § 731(a)	**$ 50,000**

The IRC §731(c) distribution of marketable securities issue is the opposite issue of the IRC §721(b) investment company pitfall discussed previously. The distribution of marketable securities issue occurs when the general partners and the trustees of the IEPT decide to distribute marketable securities in kind to a spouse who contributed assets other than cash or marketable securities. The investment company pitfall results in the recognition of gain when the husband and wife contribute nonidentical marketable securities to a FLP.

Some asset protection planners are of the opinion that this issue is completely avoided by having the husband and wife execute an affidavit of intent that deems any property contributed by either spouse as a gift of one-half of such property to the other spouse.[15] Although the affidavit of intent will eliminate any gain to either husband or wife in the event protective measures are undertaken by the foreign trustee and the FLP is liquidated, it does not solve the deemed marketable securities distribution problem in its entirety. In the previous example, let us assume that the affidavit of intent was properly executed. Instead of making a distribution of all of the assets of the FLP in a dissolution of the FLP, pursuant to a domestic relations order, however, the trustees make a distribution of all of the marketable securities *only* to the wife. The result is the wife will recognize gain of $125,000 computed as follows:

Marketable Securities IRC § 731(c)	$300,000
IRC § 731(c)(3)(B) Adjustment ($300,000 − $200,000) × 50%)	(50,000)
Amount of money deemed distributed under IRC § 731(c)	250,000
Wife's basis in her partnership interest ($100,000 + $25,000)	125,000
Gain Recognized Under IRC § 731(a)	**$125,000**

In almost all cases, the distribution of marketable securities issue is only a concern for a two-settlor foreign IEPT structure. Even then, the issue only occurs on a very infrequent basis. Unfortunately, when it occurs, the unexpected amount of gain may be quite significant. Further, the deemed marketable distribution issue generates a substantial administrative issue, because before any distribution of marketable securities can be made, both husband and wife need to know their respective basis in the partnership and then the computations must be made with respect to the marketable securities distributed.

Similar to remedying the investment company pitfall issue,[16] the deemed distribution of marketable securities issue may be remedied by creating two FLPs, one for the husband and one for the wife, in combination with a two-settlor foreign IEPT. Still another solution is to use a single member LLC, rather than an FLP. As mentioned before, a single member LLC would com-

pletely be ignored for tax purposes. The assets of the single member LLC would be taxed as if they were owned directly by the foreign IEPT. Similar to the investment company pitfall, the deemed distribution of marketable securities issue only applies to partnership taxation. The deemed distribution of marketable securities issue would not be an issue for a single member LLC.

The Grantor Trust May Not Be Recognized as a Separate Taxpayer

A partnership for tax purposes requires that there are two partners. In regard to single settlor structures, will a grantor trust be treated as a separate entity for tax purposes? In the event that the Internal Revenue Service takes the position that the grantor trust is not a legal entity for tax purposes and should be completely ignored, then the client would be both the general partner and limited partner of the FLP. In this event, since there would only be one partner, there would be no partnership for tax purposes. Although this may be a theoretical issue that is discussed along the sandy beaches by some planners, it probably does not have much relevance. If the FLP is disregarded for tax purposes, it would be classified as a non-entity for tax purposes. In this event, it would be taxed like a single member LLC; that is, not at all.

One Percent of the FLP's Assets Are Left to the Creditor

As noted, when the legal waters become rough, the foreign trustee votes to dissolve the FLP. One percent of the assets of the FLP are transferred to the general partner. These assets will be available to satisfy the claims of any creditors. With most clients, this is not an issue. For example, if a client with a 1 percent general partner interest has protected her entire $5 million net worth in a foreign IEPT structure (all of which is owned by the FLP and the FLP is liquidated), only $50,000 (one percent of $5 million) is available to her creditors. Typically, a client's legal defense costs and living expenses will easily consume this amount, and therefore, the creditor will not have access to it. The same analogy, however, cannot be made for the super wealthy client. For example, if a client has a net worth and protects $135 million of assets, a creditor may be able to attach up to $1.3 million of the client's assets when the FLP is liquidated. In the case of a single member LLC, however, nothing would be available to a client's creditors when the single member LLC is liquidated.

Clients Not Respecting the 1% / 99% Split

One of the key components to any integrated estate plan is that the client must respect the separate and distinct nature of each entity. In the event a client does not respect the separateness of a structure, a court may conclude that the entity was a sham, the alter ego, illusory, or the agent of the person creating the entity.

Unfortunately, many times when contributions are made to the FLP or distributions from are made from the FLP, the accounting and tax records do not reflect the fact that the general partner(s) owns 1 percent of the FLP and the foreign IEPT owns 99 percent of the FLP. Naturally, in the event of a legal crisis, the opposing counsel will argue that this incident of failing to respect the separateness of the structure, plus any other related oversights by the client, proves that the integrated estate planning structure is a sham and should be declared invalid.

In the case where a single member LLC is used instead of an FLP, there is no 1%/99% split. The foreign IEPT owns 100 percent of the single member LLC. Therefore, any distributions by the single member LLC to the foreign IEPT will be disregarded for tax purposes. Similar to an FLP, however, any distributions by the single member LLC to the client would generally represent distributions to a beneficiary and must be properly recorded by a trustee resolution.

DISADVANTAGES OF THE NON-ENTITY LLC

Whereas a non-entity LLC solves all of the aforementioned FLP disadvantages, a non-entity LLC has the following four disadvantages.

1. The single member LLC files no tax return, whereas the partnership tax return is evidence supporting that a valid legal entity was created;
2. Some states impose a franchise tax on LLCs;
3. Some states have not adopted the "check the box" regulations; and
4. Some state LLC statutes do not provide for charging order protection.[17]

The Partnership Return Is Evidence Supporting a Valid Legal Entity Was Created

Similar to the 1%/99% issue discussed previously, another element that judges use in determining whether a valid legal entity was created and the separateness of the entity was respected is whether the entity properly filed its tax returns. When defending against an argument from opposing counsel that the FLP is a sham, it always helps to be able to submit into evidence several years of tax partnership tax returns. In the case of a non-entity LLC, however, there is no tax return that is filed. Therefore, this element of evidence supporting the position that the non-entity LLC is a valid entity will not be present.

It should be noted that filing a tax return is only one of the elements a judge looks at when determining whether a client respected the separateness of the entity. Bank accounts, letterhead, business cards, contracts, and invoices are other elements proving the separateness of the entity.

It should be noted that filing a tax return is only one of the elements a judge looks at when determining whether a client respected the separateness of the entity. Bank accounts, letterhead, business cards, contracts, and invoices are other elements proving the separateness of the entity. Accounting records, consents to action, and LLC minutes of member meetings are also other facts that support that the client respected the separateness of the entity. Based on all of these factors, the lack of an entity tax return, which is not to be filed in the case of a single member LLC, may not be a major factor proving whether the client respected the separateness of the structure.

Some States Impose a Franchise Tax on LLCs

In particular, Texas and Tennessee impose a franchise tax computed on both the income and capital of an LLC. In Texas, the franchise tax is computed at a rate of 4.5 percent of current earnings and 0.25 percent of capital retained within the LLC. This franchise tax is not imposed on FLPs. The result is that in most cases, it is not cost beneficial to create an LLC in either Texas or in Tennessee.

Some States Have Not Adopted the "Check the Box" Regulations

Presently, over two-thirds of the states have explicitly adopted the check the box regulations. Colorado and Louisiana have state laws that require the state to follow federal laws. Therefore, in regard to these states, a single member LLC will be disregarded for both federal and state income tax purposes.

In regard to the states that have not decided whether to follow the check the box regulations, however, the non-entity LLC must be drafted so that it will avoid being classified as a corporation under the old four factor test of *Morrissey v. Commr.*[18] Under the four factor test, an entity would be classified as a corporation if it possessed three of the following four factors.

1. Centralized management
2. Limited liability
3. Continuity of life
4. Free transferability of interests

Some State Statutes Do Not Provide for Charging Order Protection

As noted, sometimes when the legal waters become rough, the foreign IEPT, as the 99 percent limited partner, will cause a liquidation of the domestic FLP. In these cases, the asset protection structure is

not relying on charging order protection. There may be times when the trustees of the foreign IEPT will decide not to liquidate the domestic FLP.

In this event, under all states limited partnership laws except Louisiana, a partner's interest receives charging order protection as the creditor's sole remedy. Charging order protection allows a creditor to receive merely a distribution of profits attributable to the debtor/partner's share, when and if such distribution is ever made. Although all states but one provides charging order protection for limited partners, the same is not true for limited liability companies. Again, it is imperative that the asset protection planner consult state law before deciding in favor of a single member LLC.

CONCLUSION

The single member LLC provides several distinct advantages over the FLP by avoiding several possible remote tax pitfalls attributable to federal partnership taxation. The single member LLC has its own pitfalls, however, and most are consequences of state law. Generally, due to the franchise tax, in Texas and Tennessee, the non-entity LLC will not be cost beneficial when compared to the FLP. The same result may occur if the single member LLC is taxed as a corporation. Finally, the drafter must always check an LLC statute to insure that such statute provides for charging order protection. Only after determining the nature of the assets that are going to be contributed to either the FLP or the single member LLC, as well as the relevant state law, may an asset protection planner advise his or her client which is the best entity to be combined with the typical foreign IEPT.

ENDNOTES

1. On January 1, 1997, the Treasury Department promulgated the "check the box" regulations for selecting how a partnership or limited liability will be classified for tax purposes. Under the regulations, a two member LLC may elect to be taxed either as a corporation or a partnership, and a single member (i.e., single member) LLC may elect to be taxed as a corporation or a non-entity. Treas. Reg. §301.7701-3(a). This article is concerned with the single member LLC that has made an election to be classified as a non-entity for tax purposes.
2. Generally, a client executes an Affidavit of Intent. Under the terms of the affidavit, any direct gifts of property to the FLP are deemed to be a 1 percent capital contribution by the general partner(s) and a 99 percent gift to the IEPT followed by a 99 percent capital contribution from the IEPT.
3. Transferring subchapter S stock directly to the FLP will terminate the S election. Under IRC §72(u), an annuity will lose its tax deferral if it is owned by anything other than a natural person or a grantor trust (i.e., an IEPT is a grantor trust). It is uncertain whether a partner of an FLP may deduct mortgage on a personal residence or whether an FLP is eligible for the one-half million dollar exclusion from the sale of a personal residence. Therefore, this type of asset is typically owned directly by the IEPT.
4. Assuming the foreign trustee is only performing the compliance work for the IEPT and is *not* managing any investments, typical annual fees for a foreign trustee range from $2,000 to $4,000 per trust. If both a husband and wife create separate IEPTs, their foreign trustee fees would be from $4,000 to $8,000 per year. On the other hand, with a two-settlor trust for both husband and wife, the annual foreign trustee fees and compliance fees are only one-half the cost.
5. It should be noted that if both husband and wife wish for you to create single settlor foreign IEPTs, it often is a conflict of interest for you to represent both of them.
6. IRC §351(e)(1).
7. Treas. Reg. §1.351-1(c)(i).
8. Treas. Reg. §1.351-1(c)(ii).
9. Treas. Reg. §1.351-1(c)(5).
10. The investment company pitfall may also be avoided by (1) making inter-spousal gifts before the contribution to the FLP, (2) contributing only diversified portfolios under IRC §368(a)(2)(F)(ii), or (3) contributing enough non-marketable security assets to the partnership so that non-marketable security assets are greater than 20 percent of the fair market value of the assets of the partnership.
11. IRC §731(a).
12. IRC §752(b).
13. For example, assume that mom and dad contribute real estate subject to a mortgage directly to a child's IEPT. Mom and dad are the debtors on the mortgage. The IEPT takes the property subject to the mortgage, but never assumes it. Two years later, the IEPT transfers the real estate to the FLP when the fair market value of the property is $250, $200 is owed on the property at that time, and the adjusted basis of the property is $50. In this case, the IEPT will recognize gain in the amount of $150. Since the IEPT was never liable on the promissory note, it

not relying on charging order protection. There may be times when the trustees of the foreign IEPT will decide not to liquidate the domestic FLP.

In this event, under all states limited partnership laws except Louisiana, a partner's interest receives charging order protection as the creditor's sole remedy. Charging order protection allows a creditor to receive merely a distribution of profits attributable to the debtor/partner's share, when and if such distribution is ever made. Although all states but one provides charging order protection for limited partners, the same is not true for limited liability companies. Again, it is imperative that the asset protection planner consult state law before deciding in favor of a single member LLC.

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1. On January 1, 1997, the Treasury Department promulgated the "check the box" regulations for selecting how a partnership or limited liability will be classified for tax purposes. Under the regulations, a two member LLC may elect to be taxed either as a corporation or a partnership, and a single member (i.e., single member) LLC may elect to be taxed as a corporation or a non-entity. Treas. Reg. §301.7701-3(a). This article is concerned with the single member LLC that has made an election to be classified as a non-entity for tax purposes.
2. Generally, a client executes an Affidavit of Intent. Under the terms of the affidavit, any direct gifts of property to the FLP are deemed to be a 1 percent capital contribution by the general partner(s) and a 99 percent gift to the IEPT followed by a 99 percent capital contribution from the IEPT.
3. Transferring subchapter S stock directly to the FLP will terminate the S election. Under IRC §72(u), an annuity will lose its tax deferral if it is owned by anything other than a natural person or a grantor trust (i.e., an IEPT is a grantor trust). It is uncertain whether a partner of an FLP may deduct mortgage on a personal residence or whether an FLP is eligible for the one-half million dollar exclusion from the sale of a personal residence. Therefore, this type of asset is typically owned directly by the IEPT.
4. Assuming the foreign trustee is only performing the compliance work for the IEPT and is *not* managing any investments, typical annual fees for a foreign trustee range from $2,000 to $4,000 per trust. If both a husband and wife create separate IEPTs, their foreign trustee fees would be from $4,000 to $8,000 per year. On the other hand, with a two-settlor trust for both husband and wife, the annual foreign trustee fees and compliance fees are only one-half the cost.
5. It should be noted that if both husband and wife wish for you to create single settlor foreign IEPTs, it often is a conflict of interest for you to represent both of them.
6. IRC §351(e)(1).
7. Treas. Reg. §1.351-1(c)(i).
8. Treas. Reg. §1.351-1(c)(ii).
9. Treas. Reg. §1.351-1(c)(5).
10. The investment company pitfall may also be avoided by (1) making inter-spousal gifts before the contribution to the FLP, (2) contributing only diversified portfolios under IRC §368(a)(2)(F)(ii), or (3) contributing enough non-marketable security assets to the partnership so that non-marketable security assets are greater than 20 percent of the fair market value of the assets of the partnership.
11. IRC §731(a).
12. IRC §752(b).
13. For example, assume that mom and dad contribute real estate subject to a mortgage directly to a child's IEPT. Mom and dad are the debtors on the mortgage. The IEPT takes the property subject to the mortgage, but never assumes it. Two years later, the IEPT transfers the real estate to the FLP when the fair market value of the property is $250, $200 is owed on the property at that time, and the adjusted basis of the property is $50. In this case, the IEPT will recognize gain in the amount of $150. Since the IEPT was never liable on the promissory note, it

will not be allocated any of recourse note for determining basis.

14. IRC §671.

15. It should be noted that many times clients will not want to execute an affidavit of intent due to the divorce issues previously discussed.

16. The investment company pitfall may also be avoided by (1) making inter-spousal gifts before the contribution to the FLP, (2) contributing only diversified portfolios under IRC §368(a)(2)(F)(ii), or (3) contributing enough non-marketable security assets to the partnership so that non-marketable security assets are greater than 20 percent of the fair market value of the assets of the partnership.

17. This concern can be addressed simply by choosing a state whose LLC law does offer such protection, e.g., Delaware.

18. 296 US 344 (1935).