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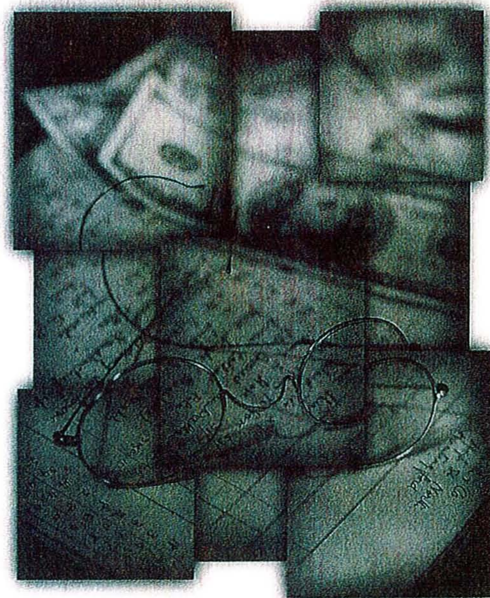

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Offshore Limited Liability Companies Revisited for Asset Protection and Tax Purposes

BY ALEXANDER A. BOVE, JR. AND MARK MERRIC

INTRODUCTION

There are various offshore asset protection vehicles[1] such as the integrated estate planning trust (i.e., an offshore trust that has been designed for both asset protection and estate planning purposes), the civil foundation (e.g., Stiftung), the hybrid company, the offshore limited partnership, and the offshore limited liability company. While the offshore integrated estate planning trust ("IEPT") is the most common asset protection vehicle, some planners have advocated using an offshore LLC as the primary, if not sole, asset protection vehicle for a client. Unfortunately, jurisdiction, comity, and conflicts of law issues make the LLC a much less attractive option than the offshore IEPT. Nevertheless, in many instances, the offshore LLC may be one of the better entities to combine with the offshore IEPT.

This article discusses the following key issues in regard to evaluating the use of an offshore LLC:

I. The Domestic FLP and Asset Protection;
II. The Offshore LLC;
III. Jurisdictional Issues;
IV. Comity Issues;
V. Conflict of Law Issues;
VI. Summary Comparison of the Offshore LLC to the Offshore IEPT;
VII. The Offshore LLC as a Component of the Offshore IEPT; and
VIII. Taxation of an Offshore LLC

I. THE DOMESTIC FLP AND ASSET PROTECTION

One of the primary reasons why an IEPT and a civil foundation are stronger forms of asset protection is that when properly designed and implemented, these offshore vehicles may move the final legal battle abroad. This is done by removing both personal, and in rem jurisdiction. In regard to the offshore LLC owned by U. S. person(s), an offshore LLC may also remove personal jurisdiction, providing that the manager resides in a properly selected offshore jurisdiction with no U.S. contacts. However, unless the offshore LLC is combined with the offshore IEPT, similar to a domestic limited partnership, the property interest (i.e., the membership interest) still remains in the U.S. and is subject to the jurisdiction of the U.S. courts (see Part VII of this article). For this reason, an offshore LLC, as the sole asset protection planning tool provides less protection than an offshore IEPT, but greater protection than a domestic limited partnership.

In order to understand this issue of personal jurisdiction, one must first understand the protection provided by a domestic family limited partnership.[2] When a domestic limited partnership is

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used as the sole asset protection planning tool, a creditor may pressure a client into an unfavorable settlement through one of the following four common remedies:

1. A charging order;
2. A judicial order restricting the activities of the partnership;
3. A judicial foreclosure sale of the limited partnership interest; or
4. A "piercing the veil" argument.

A. Charging Order

Under the Uniform Limited Partnership Act and the Revised Uniform Limited Partnership Act, the initial remedy (and in some states the sole remedy) available to a judgment creditor is to obtain a "charging order."[3] The same is true for all limited liability company statutes, except for Wyoming's statute.

A charging order is a specific court order, issued pursuant to statute, allowing a court to charge or hold liable any distributions of the debtor/partner's partnership interest for payment of the amount due to the judgment creditor. A charging order is similar to an assignment of income. However, it is more restrictive than an assignment of income in that it is an assignment of the distributions from the LLC when and if such distributions are made. A creditor who receives the benefits of a charging order is not entitled to any voting fights, and therefore, the creditor may not vote for a distribution. Since the client/debtor retains all the voting fights, the client will have control over when, if ever, there will be a distribution (depending, of course, on the debtor's degree of control in any event).

This ability to delay payment to a judgment creditor forces a waiting game. Charging order protection delays the judgment creditor from collecting from the partnership. But for how long? In the event the judgment creditor may be delayed for a sufficient period of time, the creditor may agree to a settlement on a discounted basis. However, if the debtor-partner ever needs a distribution from the partnership, the waiting game is over because as soon as the assets are distributed, the charging order requires that they be distributed to the judgment creditor to the extent of the judgment. Therefore, the question becomes who can wait the longest: the judgment creditor or the client? This is why charging order protection is generally only a short-term asset protection feature.

B. Judicial Order Restricting the Activities of the Partnership

Unfortunately, a judge may also attempt to restrict the actions of the general partner (or manager in the case of an LLC) when he issues a charging order.

ARTICLE 7 of the Revised Uniform Limited partnership act states:

> 703. Rights of a Creditor - On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. *To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest.* This [Act] does not deprive any partner of the benefit of any exemption laws applicable to his [or her] partnership interest. (emphasis added).

At first glance, one might think that a charging order only applies to the partner's or member's interest. However, in some cases a judge will issue a charging order that substantially restricts the actions of the general partners in regard to operations of the partnership. The following example of a charging order

issued by the District Court of Colorado provides an illustration of just how restrictive a charging order may be.

> "The partnership is directed to pay to the [plaintiff s] law firm, as for (sic) the Petitioner's receiver, present and future shares of any and all distributions, credits, drawings, or payments to said law firm (sic) until the judgment is satisfied in full, including interest and costs.
>
> Until said judgment is satisfied in full, including interest and costs, the partnership shall make no loans to any partner or anyone else.
>
> Until said judgment is satisfied in full, including interest and costs, the partnership shall make no capital acquisitions without either Court approval or approval of the Judgment Creditor (sic) herein.
>
> Until said judgment is satisfied in full, including interest and costs, neither the partnership nor its members shall under take (sic), enter into, or consummate any sale, encumbrance, hypotheca-tion, or modification of any partnership interest without either Court approval or approval of the Judgment Creditors herein.
>
> Within ten days of service of a certified copy of this Order upon the registered agent of the part-nership, the partnership shall supply to the Judgment Creditors, a full, complete, and accurate copy of the Partnership Agree-ment, including any and all amendments or modifications thereto; true, complete, and accurate copies of any and all federal and state income tax or informational income tax returns filed with (sic) the past three years; balance sheets and profit and loss statements for the past three years; and balance sheet and profit and loss statement for the most recent present period (sic) for which same has been com-pleted. Further, upon ten day notice from Petitioners to the partnership, all books and records shall be produced for inspection, copying, and examination in the Petitioners (sic) office.
>
> Until said judgment is satisfied in full, including all costs and inter-est thereon, all future statements reflecting cash position, balance sheet position, and profit and loss shall be supplied to Petitioners within thirty days of the close of the respective accounting period for which said data is or may be generated."[4]

A charging order that controls both the distributions from the LLC as well as the operations of the LLC substantially limits the LLC as an asset protection tool. For example, what if the client needs money? If a distribution is made from the LLC, it must be turned over to the judg-ment creditor. However, what about a loan? In the case where the charging order is similar to the one discussed above, the charging order prevents the partnership from loaning any person (including the debtor partner) any money. Also, such a charging order restricts the use of cash to purchase capital acquisi-tions. The purpose of such a charging order is not only to control distributions, but to insure that the cash would be available for a distribution to satisfy the charging order.

It should be noted that many practitioners, including the authors, believe that a judge does not have authority to issue an order restricting the operations of the partnership. First, in many cases, the partnership will not be a party to the debtor's action.[5] Second, while the literal language of the statute states a judge may charge the membership interest, it says nothing regarding issuing an order restricting the activities of the partnership.

C. Judicial Foreclosure Sale of the Partnership Interest

Even if a U.S. judge cannot control the operations of an offshore LLC (i.e., does not have personal jurisdiction over the manager), if a U.S. judge has personal jurisdiction over the client/debtor, a U. S. judge still has in rem jurisdiction over the membership interest owned by such client/debtor. What if the U.S. judge ordered the judicial foreclosure sale of a member's interest?

Some practitioners have argued that the charging order is the sole remedy that may be granted to a creditor. If the charging order is the sole remedy, then the creditor is forced to play the waiting game, since the client/debtor typically controls when, if ever, any distributions will be made from the partnership.

In cases where the charging order is not the sole remedy, it is possible that a U.S. judge could order a judicial foreclosure sale of a membership interest, to the extent of the proceeds from the sale, the creditor would receive partial, and possibly full, satisfaction of his claim. In addition to the unsatisfied claim of the original judgment creditor, the client now has two additional problems. First, the third party purchaser would receive the rights of an assignee and be entitled to any distributions until the partnership is dissolved. On the other hand, under the charging order, the judgment creditor only had the right to receive distributions until the original debt was paid. Second, in order to end the waiting game, the client must now negotiate to purchase the membership interest from the third party.

In addition to the aforementioned problems, there is also the psychological effect on the client when he realizes that his membership interest will be sold at a judicial foreclosure sale at a substantially discounted value. How much would a third party purchaser pay to be an "assignee" without any voting rights entitled to distributions when and if ever made? In many cases, this amount could easily be as little as ten cents on the dollar. How many clients will be willing to see their membership interest, which for purposes of an example represents, say, one million dollars of LLC assets, sell for a substantially discounted price (i.e., ten cents on the dollar or $100,000) at a judicial foreclosure sale?

Obviously, the degree of asset protection provided by an FLP, a LLC or an offshore LLC would be significantly increased if a charging order was the creditor's sole remedy. However, in regard to partnership interests, when the issue has been decided before a court, the majority of states have allowed for the judicial foreclosure sale of a partner's interest. The minority rule is that a charging order is the creditor's sole remedy. To date, in regard to membership interests of an LLC, there has not been any state case law in regard to whether a charging order is the sole remedy for a creditor.

On the other hand, in regard to limited partnerships, the statutes of three states specifically provide that a charging order is the sole remedy of a creditor. For limited liability companies, the results are even more favorable: the statutes of eight states specifically provide that a charging order is the sole remedy. The following table (page 40 and 41) depicts the status of state charging order protection for

both limited partnerships and limited liability companies. The table indicates whether (1) a state court or state statute has decided that it is the sole remedy, (2) whether the state statute provides for charging order protection but as of yet it has not ruled on the issue (these states are denoted with an X), or (3) whether a state court has ordered the judicial foreclosure sale of a partnership interest.

II. THE OFFSHORE LLC

Offshore LLCs are also referred to as a limited life company ("LLC"), a limited duration company ("LDC"), and a Society with Restricted Liability ("SRL"). In fact, the first U.S. LLC statute (i.e., the Wyoming statute) was fashioned after the Sociedada Limitada of Mexico and other South American Countries.

For the most part, offshore LLC legisation is, in concept at least, fashioned primarily after the typical domestic LLC statute, providing, in effect, a partnership where no partner is exposed to personal liability. But N.B.: Many of the offshore LLC statutes are too casually drafted and there are some serious oversights, which may be troublesome or even fatal to the asset protection issue. For instance, the Cayman Islands LLC statute does not specifically prohibit a creditor from reaching a member's share. Further, privacy may be sacrificed in those jurisdictions that require the identity of the LLC members to be recorded with the articles of organization.[6]

Following is a chart (page 42) illustrating a comparison of a randon selection of offshore jurisdictions on certain key LLC issues.

So why use an offshore LLC? If we are concerned about leaving assets onshore, an incredible increase in protection can clearly be achieved by moving them beyond the reach of any domestic court. In a properly structured offshore LLC that is also in a properly selected jurisdiction, if the assets (other than U.S. real estate[7]) are owned by a foreign LLC, they may be well beyond the reach of the U.S. court's jurisdiction.

However, if the offshore LLC is utilized as the sole means of asset protection, then a U.S. defendant will directly own a membership interest in the LLC. What then? Certainly if the court has jurisdiction over that individual, it can order the individual to take action with regard to any interests held by the individual, whether tangible or intangible, including an interest in an offshore LLC. The question becomes what action could the court take?

III. JURISDICTIONAL ISSUES

As noted above, these are the four common remedies a judge could order when pursuing a domestic limited partner's or member's interest:

1. Charging order;
2. An order restricting the activities of the partnership;
3. Judicial foreclosure sale of the limited partnership interest; or a
4. Piercing the veil argument.

Will these orders be enforceable against an offshore manager of an offshore limited liability company?

A. Personal Jurisdiction Over Client/ Debtor - Charging Order

While a U.S. judge may not be able to obtain personal jurisdiction over the offshore manager or the assets of the offshore LLC (and therefore, also unable to obtain jurisdiction over the assets abroad), he still has jurisdiction over the client as well as the client's assets. The client's assets include his membership interest in the offshore LLC. Therefore, there is little reason to doubt that a U.S. judge will be able to issue a charging order (or in the alternative a constructive

Table 1

Charging Order Chart by State

State	Limited Partnership (X=charging order protection by statute)	Limited Liability Company (X=charging order protection by statute)	Allows for judicial foreclosure sale of member interest by statute	Allows for judicial foreclosure sale of p/s interest by case law
Alabama	X[8]	Sole remedy by statute[9]		
Alaska	Sole remedy by statute[10]	Sole remedy by statute[11]		
Arizona	Sole remedy by statute[12]	Sole remedy by statute[13]		X[14] Subsequent statute changes this to a sole remedy state
Arkansas	X[15]	X[16]		
California	X[17]	X[18]		X[19]
Colorado	X[20]	X[21]	X[22]	
Connecticut	X[23]	X[24]		X[25]
Delaware	X[26]	X[27]		
District of Columbia	X[28]	X[29]		
Florida	X[30] Sole remedy by case law	X[31]		
Georgia	X[32]	X[33]		X[34]
Hawaii	X[35]	X[36]	X[37]	
Idaho	X[38]	X[39]		
Illinois	X[40]	X[41]	X[42]	
Indiana	X[43]	X[44]		
Iowa	X[45]	X[46]		
Kansas	X[47]	No charging order language		
Kentucky	X[48]	X[49]		
Louisiana	No charging order language	X[50]		
Maine	X[51]	X[52]		
Maryland	X[53]	X[54]		X[55]
Massachusetts	X[56]	X[57]		
Michigan	X[58]	X[59]		
Minnesota	X[60] Sole remedy by case law	Sole remedy by statute[61]		

Mississippi	X[62]	X[63]		
Missouri	X[64]	X[65]		X[66]
Montana	X[67]	X[68]		
Nebraska	X[69]	No charging order language		
Nevada	X[70]	X[71]		
New Hampshire	X[72]	X[73]		X[74]
New Jersey	X[75]	Sole remedy by statute[76]		
New Mexico	X[77]	X[78]		X[79]
New York	X[80]	X[81]		
North Carolina	X[82]	X[83]		
North Dakota	X[84]	No charging order language[85]		
Ohio	Sole remedy by case law[86]	X[87]		
Oklahoma	Sole remedy by statute[88]	Sole remedy by staute[89]		
Oregon	X[90]	X[91]		
Pennsylvania	X[92]	No charging order language		X[93]
Rhode Island	X[94]	X[95]		
South Carolina	X[96]	X[97]	X[98]	
South Dakota	X[99]	X[100]	X[101]	
Tennessee	X[102]	Sole remedy by statute[103]		
Texas	X[104]	X[105]		X[106]
Utah	X[107]	X[108]		
Vermont	X[109]	X[110]	X[111]	
Virginia	X[112] Sole remedy by case law	No charging order language; however, implied by statute[113]	Implied by statute[114]	
Washington	X[115]	X[116]		
West Virginia	X[117]	X[118]	X[119]	
Wisconsin	X[120]	X[121]		
Wyoming	X[122]	No charging order language		

This table is reprinted with the permission of CCH from a forthcoming book, *The Asset Protection Planning Guide: A State-of-the-Art Approach to Integrated Estate Planning*, by Barry Engel, David Lockwood, and Mark Merric. The book will also be included in a forthcoming electronic publication, *CCH Solutions for Financial Planning*.

Table 2
Comparison of Certain LLC Statutes

Jurisdiction	Required Members	Public Disclosure of Members Required*	Specific Charging Order Protection	Duration**
Nevis	1	No	Sole Remedy	Infinite
Barbados	2	No	No	50 Years
Isle of Man	2	Yes	No	30 Years
Turks & Caicos	2	No	No	50 Years (extended to 150 years)
Cayman Islands (LDC)	2	Unclear	No	Indefinite
Cayman Islands (LLC)	1	No	No	Indefinite

* Most offshore LLC statutes only require the designation of one or more managers, if any, in the articles of organization, so the public will know who has authority to bind the LLC. Identities of the members are usually kept private.
** Although some statutes provide for an indefinite duration, all provide for termination when the death or bankruptcy of a member causes the number of members to fall below the minimum requirement.

trust) over any distributions received by the client/debtor.

B. Personal Jurisdiction - Local Manager- Restricting the Activities of the Partnership

If the manager of an offshore LLC were subject to the jurisdiction of the U.S. and hence the charging order, he would be subject to the aforementioned orders, and he may be unable to take further protective measures to safeguard the assets of the offshore LLC. In this respect, an offshore LLC would not provide much more protection than its domestic counterpart. This is because the client's interest would be subject to the personal jurisdiction of the U.S. courts, and, through personal jurisdiction over the manager of the offshore LLC, the assets and operations of the offshore LLC would be subject to the personal jurisdiction of the U.S. courts. For these reasons, during times of a legal crisis, the manager of the offshore LLC should be an offshore manager not subject to U.S. personal jurisdiction.

C. In Rem Jurisdiction - Judicial Foreclosure Sale of the Membership Interest

If a judge has jurisdiction over the member's interest, he may order the judicial foreclosure sale of the member's interest. However, if this is the case, will a foreign court respect such an order?

D. Pierce the Veil Type Arguments

What if a U.S. judge pierces the veil of an offshore LLC? At present, there is no case law on this subject. Further, there is no case law that has been upheld[123] where a limited partnership's veil was pierced. However, as more of these entities are used for asset protection purposes, if the client does not respect

the separateness of the partnership as an entity, a U.S. judge may easily find that the entity should be disregarded under an agency theory, alter-ego theory, or sham theory.[124] Will the offshore court respect a U.S. court's finding that the veil should be pierced? Unfortunately, the question is unanswered, because this is a comity issue. Further, in most, if not all, offshore jurisdictions, such a finding is probably not a conflict of law issue.

The diagram below depicts the U.S. Jurisdictional issues as applied to an offshore LLC.

III. COMITY ISSUES

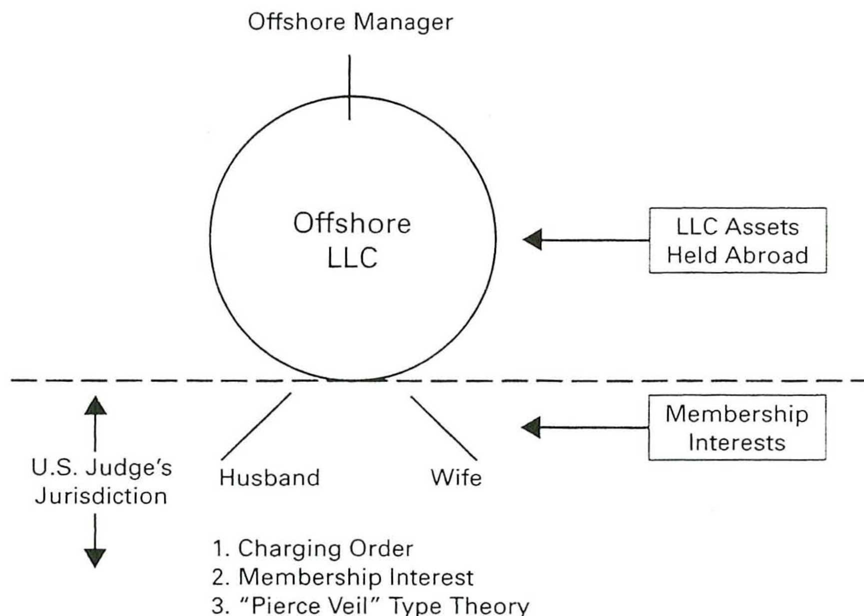
Assuming in a properly selected jurisdiction a U.S. judge is unable to obtain jurisdiction, there is still the question: will the foreign court respect the U.S. judgment? In other words, is there a treaty, comity or law analogous to the full faith and credit clause of the U.S. Constitution where the offshore jurisdiction would be required to enforce the U.S. judgment?

Unfortunately, this is where the offshore LLC statutes fall drastically short in regard to asset protection when comparing the protection afforded by an offshore IEPT. In regard to an offshore IEPT, jurisdictions like the Cook Islands and Nevis provide no comity to another jurisdiction's judgment if it is inconsistent with local law in regard to an international trust (IEPT). The same is not true for offshore LLC statutes. Therefore, it is uncertain whether an offshore court would recognize an order by a U.S. court to pierce the veil, to enforce a charging order, or to allow for the judicial foreclosure sale of the member's interest.

IV. CONFLICTS OF LAW ISSUES

However, even if an offshore jurisdiction does respect a U.S. judgment (i.e., there is no specific statute or case law denying comity), whether the offshore court will uphold the U.S. judgment may well depend on whether the U.S. judgment is in conflict with local law. In this respect, if an offshore jurisdiction LLC statute states a "charging order" is the sole remedy for a creditor, this may well create a conflict of law issue. For example, if a U.S. judge issues an order piercing the

Figure 1



veil, restricting the activities of the partnership, or the judicial foreclosure sale of the member's interest, such an order would be in conflict with the local law of the offshore jurisdiction providing that the creditor's sole remedy is a charging order.

In this regard, the chart under Part II of this article becomes critical. It should be noted that only Nevis refers to charging order protection. Further, as discussed below the Nevis statute is a sole remedy statute. In order to understand the difference between the types of offshore LLC statutes in regard to charging order protection, the following discussion compares the Isle of Man LLC statute to the Nevis LLC statute.

A. Isle of Man LLC Statute

Section 16 of the Isle of Man Limited Liability Companies Act of 1996 states:

> 16. (1) The interest of all members in a limited liability company constitutes the personal estate of the member, and may be transferred or assigned as provided in the operating agreement.
> (2) If all members of a limited liability company other than the member proposing to dispose of his interest do not approve of the proposed transfer or assignment by unanimous written consent, the transferee of the member's interest shall have no right -
> (a) to become a member of the limited liability company; or
> (b) to participate in the management of the business and affairs of the limited liability company.
> (3) Such a transferee shall only be entitled to receive the share of profits or other compensation by way of income and the return of contributions, to which the original member would otherwise have been entitled.

At first glance, it appears that the Isle of Man statute provides the standard charging order protection found under the Revised Uniform Limited Partnership Act. If this were the case, the question would still remain whether the offshore court would respect an order piercing the veil or for the judicial foreclosure sale of the client/member's interest.

However, a careful reading of Section 16(3) indicates that this is not the case. There is no specific charging order language in the Isle of Man statute. Rather, the Isle of Man statute contemplates the transfer (either directly to the creditor or the judicial foreclosure sale) of a member's interest; and then similar to a charging order, after the transfer, the Isle of Man limits the rights of the transferee to that of an assignee.

Further, the specific language in Section 16(3) of the Isle of Man is much broader than a charging order. A charging order provides the creditor will receive a distribution, when and if such distribution is ever made by the manager of the LLC. The Isle of Man statute may be construed to allow a member to demand his proportionate share of income as well as his original capital contribution. It should be noted that when a client creates an offshore LLC for asset protection purposes, typically the client (and possibly her spouse) will be the sole persons making capital contributions. If a creditor receives the right to demand the original capital contributions of the client/member, such amount may well be an amount equal to the majority of the assets owned by the offshore LLC. It should be noted that the Isle of Man LLC statute was modeled after the Wyoming LLC statute. Unfortunately, as noted in the table in Part I of this article, Wyoming is one of only four states that does not have charging order language in their LLC statutes.

B. Nevis LLC Statute

In contrast, the Nevis Limited Liability Company Ordinance of 1995 is much more similar to the Revised Uniform Limited Partnership Act than the Isle of Man Statute. Sections 42 and 43 of the Nevis Limited Liability Company Ordinance state:

> 42. (1) Unless provided otherwise in the operating agreement and subject to the restrictions in subsection (2), a member's interest in a limited liability company is assignable in whole or in part.
>
> (2) (a) Unless provided otherwise in the operating agreement, and except as provided in paragraph (b), an assignment does not entitle the assignee to vote on matters on which members may vote, to participate in the management and affairs of the limited liability company or to become, or to exercise any rights of, a member, nor is an assignee responsible for fulfilling fiduciary obligations for which members are responsible, if any. An assignment entitles the assignee to receive, to the extent assigned, *only those distributions to which the assignor would be entitled* and such share of profits, losses, income, gain, deductions, and credits which were allocable to the assignor pursuant to the, operating agreement. (emphasis added).
>
> (b) Unless provided otherwise in the operating agreement, an assignee of a member's interest may, to the extent assigned, become a member with the full rights and powers of the assignor, and is subject as a member to the same restrictions and liabilities as the assignor, including any liability of the assignor to make capital contributions, if the members other than the assignor and assignee consent to such assignee becoming a member.
>
> (c) The assignee is not released from his liability to make capital contributions to the limited liability company, until such time as the assignee satisfied such requirement. . . .
>
> 43. (1) On application to a court of competent jurisdiction by any judgment creditor of a member of a limited liability company, the court may charge the member's interest with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has

only the rights of an assignee of the member's interest.

(2) Unless otherwise provided in the operating agreement, the member's interest charged may, but need not, be redeemed at any time:

(a) with the separate property of any member, to any one or more members; or

(b) with respect to property of the limited liability company, to any one or more of the members whose interests are not charged, on the consent of the members whose interests are not charged, if all members are responsible for management duties pursuant to Section 44(l), or on the consent of the managers whose interests are not charged, if managers are responsible for management duties pursuant to Section 44(2).

(3) *Notwithstanding any other law, the remedies provided by subsection (1) shall be the sole remedies available to any creditor of a member's interest.* (emphasis added).

(4) This ordinance does not deprive any member of the benefit of any exemption laws applicable to his interest in the limited liability company.

Similar to the Isle of Man statute, the Nevis statute prevents an assignee or judgment creditor from becoming a substituted member with voting rights. However, unlike the Isle of Man statute, rather than contemplating the judicial foreclosure sale of the client/member's interest, the Nevis statute provides that the charging order is the sole remedy available to a creditor. Further, unlike the Isle of Man statute, but similar to the Revised Uniform Limited Partnership Act, the Nevis statute allows a creditor the right to distributions when, and if, made.

Synthesizing all of these facts regarding a charging order still leaves the fundamental question: If a U.S. judge orders the judicial foreclosure sale of an offshore member's interest, will the foreign court respect such an order? In the case of the Isle of Man and other offshore, jurisdictions that are, not "sole, remedy" jurisdictions, it is murh more likely that an Isle of Man Court will respect a U.S. court's judicial foreclosure sale order. Conversely, the Nevis statute is a sole remedy statute.

V. SUMMARY COMPARISON OF THE OFFSHORE LLC TO THE OFFSHORE IEPT

Simply stated an offshore LLC is not an offshore IEPT. An offshore LLC is a legal entity. The offshore LLC, like a partnership or a corporation, is owned by its members. The articles of organization and the operating agreement of the offshore LLC govern the activities of the offshore LLC, and except for prohibitions on transfer of the member's share, they do not normally contain any dispositive provisions for the underlying shares. An IEPT typically contains extensive dispositive provisions for all assets held in

the IEPT. Therefore, as discussed above, although the offshore LLC offers much greater asset protection than the domestic FLP or domestic LLC, by itself it offers little opportunity for placing extended and detailed control over the disposition of the membership interests (and therefore, the assets held by the LLC) for the family into the future.

An IEPT is typically drafted to be a discretionary trust with spendthrift provisions. An interest in a discretionary trust that has spendthrift provisions has no value to a creditor, unless the creditor can force a distribution. On the other hand, a membership interest in an offshore LLC is a property interest. If such membership interest is owned by a U.S. person, generally a judge will have jurisdiction over both the U.S. person and the membership interest. Therefore, a judge may issue a charging order, the judicial foreclosure sale of the member's interest, or possibly an order piercing the veil of the LLC.

With an offshore LLC it is uncertain whether the offshore jurisdictions would respect a U.S. court order under principles of comity. On the other hand, in regard to the comity issue as related to the offshore IEPT, certainty is provided that the offshore court would not respect the judgment in jurisdictions such as the Cook Islands and Nevis.

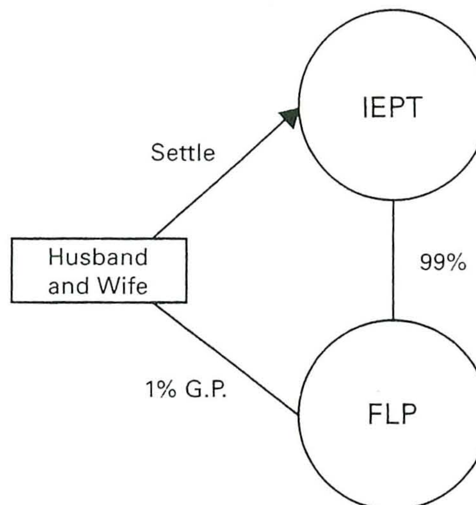
Some degree of comfort is provided with the jurisdiction of Nevis that its court might not respect a U.S. judgment that granted the creditor more rights than a charging order. This is because such a judgment would conflict with the Nevis LLC statute where a charging order is the sole remedy.

However, even if the creditor's remedy is restricted to only to a charging order (either by a U.S. judgment or if the creditor obtains a Nevis judgment), charging order protection is still only a short term solution. The question remains. Who can wait the longest: the client or the creditor? Because as soon as there is a distribution, the charging order requires such distribution to be paid to the creditor, even under the offshore jurisdiction's law.

VI. THE OFFSHORE LLC AS A COMPONENT OF AN OFFSHORE IEPT

In the typical asset protection plan, a U.S. person or family will place their liquid assets into a domestic family limited partnership, where the individual (and/or his spouse) is the general partner with a one percent interest, and an IEPT with a foreign co-trustee as a ninety-nine percent limited partner, poised for the possibility of a lawsuit against the individual or spouse.

Figure 2



When the suit hits the fan, the partnership is immediately dissolved, the liquid assets are distributed to the partners in proportion to their percentage interests, and, in the case of the IEPT, the foreign trustee (who becomes the sole trustee when the domestic trustee is removed by the foreign trustee) moves assets "offshore," out of harm's way. One of the principal attractions for clients using this scenario is that it allows them

to keep the assets local and under their control until a problem actually arises.

Some practitioners have suggested that the transfer from the partnership to the trust might be a fraudulent transfer. There are several arguments against this theory. First, the transfer to the integrated estate planning structure was done typically years before a lawsuit was on the horizon. Second, it is the foreign trustee, not the U.S. trustee or the U. S. general partner that is forcing the liquidation and transfer of the partnership assets during a legal crisis. Finally, the foreign trustee is under a legal duty to protect the assets of the offshore IEPT. His failure to diversify the assets out of the jurisdiction where a legal problem originates could easily result in a lawsuit from the beneficiaries of the offshore IEPT.

Regardless of whether the liquidation and transfer of the partnership assets could possibly be construed as a fraudulent conveyance, what if this step could be removed by using an offshore LLC? There is no reason why the offshore LLC could not carry out the same function (if it is decided that an offshore LLC is advisable in the first place) and avoid the concern. The offshore LLC could act in the place of (or in some cases in addition to) the domestic family limited partnership, except that instead of the individual and his spouse being general partners, they could be designated local managers, with no direct membership interest. The offshore IEPT would be the 100% sole member.

The important difference in the scenario using the offshore LLC is that unlike the U.S. partnership, when the suit hits the fan, the offshore LLC need not be dissolved. The local managers could simply resign or better still, they could be removed by the offshore controlling member. There would be no need to transfer the assets to the offshore IEPT.

Accordingly, it seems the offshore LLC with local managers may appear to offer the best of all possible worlds but, of course, there could be a glitch. If the offshore LLC is deemed to be "doing business" in the state, it would have to qualify under the particular state's law as a foreign LLC. When this happens, it submits itself to the jurisdiction of the state court for legal matters—a situation potentially harmful or even fatal to the asset protection objective. If on the other hand, the mere management of liquid LLC assets (e.g. cash and securities) is a particular state does not constitute doing business in the state (the more likely conclusion),[125] then the LLC will not be subject to local jurisdiction, and the arrangement could prove to be very effective and perhaps even more desirable arrangement than that involving use of a domestic family limited partnership.

Another planning possibility that avoids the "doing business" issue would be to use a domestic LLC again with the offshore IEPT. The assets would be held and managed in the U.S. by the LLC managers (who are not members). When trouble strikes, the domestic LLC would re-domicile itself pursuant to a decision by the sole member (the offshore trustee) and would instantly become an offshore LLC, free of the jurisdiction of the U.S. courts. Simultaneously, the assets would follow, with no transfers or liquidations being necessary.

VIII. FEDERAL TAXATION OF AN OFFSHORE LLC

At first, one might wonder why taxation is an issue in regard to selection of an asset protection vehicle. However, if an offshore LLC is classified as a partnership for tax purposes, rather than a single member non-entity, there are important tax issues that need to be addressed with respect to IRC §721, effectively connected income earned by a domestic partnership, and certain problem assets such as subchapter S stock, annuities, and the personal residence.

A. IRC §721 Transfer of Appreciate Property to a Foreign Partnership

While moving the final legal battle abroad is a major advantage of an offshore LLC, at present, there is some ambiguity on whether contributions of appreciated property to a foreign partnership will be subject to tax at the time of contribution. Under old §1491, which was repealed in 1997, whenever a U.S. person made a contribution of appreciated property to a foreign partnership, an excise tax of thirty-five percent (35%) was imposed.

Old §1491 was replaced with §721(c). Under §721(c), the Treasury Department has the authority to write regulations where gain would be recognized under §721(a) if the effect of the transfer of appreciated property to the foreign partnership would result in the gain being recognized by a foreign person. At this point in time, the Treasury Department has not written any regulations. However, based on the literal language of §721(c), it would appear that such a statute would not apply to a foreign partnership where all interests are owned by U.S. persons. Therefore, §721(c) in most cases should not be an issue.

B. IRC §1446 - Withholding

Under IRC §1446, if a domestic partnership is operating a U.S. business (i.e., generating effectively connected income) and such domestic partnership has a foreign partner, to the extent of the foreign partner's share of effectively connected income, the domestic partnership must withhold at a rate of 39.6%. It does not matter whether such income is actually paid to the foreign partner. Rather, the withholding requirement is imposed when the income is earned, not when it is distributed.

As noted above, an offshore LLC will generally be classified as a partnership for U.S. tax purposes. In the event that the offshore LLC owns any interests in a domestic partnership (or domestic LLC classified as a partnership) that in turn is operating a business, to the extent of the offshore LLC's interest in the domestic partnership, the domestic partnership must withhold at the rate of 39.6 percent. The penalties for failing to withhold and failure to file the appropriate tax returns can be quite substantial.

One might think that this penalty would only be imposed on a third party, unrelated to the owner of the offshore LLC. However, often an asset protection plan will involve a mix of domestic and offshore entities that are classified as partnerships for tax purposes, and the client will be the majority owner of both the domestic and offshore entities. If such an entity is classified as a domestic partnership and is owned by the client, the client is indirectly responsible for the reporting obligations.

C. Problem Assets

In the event that there is more than one member and the offshore LLC has "checked the box" to be taxed as a partnership,[126] the following types of assets have the negative tax attributes discussed below:

1. Subchapter S Stock;
2. Annuities; and
3. The Personal Residence.

If Subchapter S Stock is transferred to an entity that is classified as a partnership for tax purposes, the Subchapter S election is terminated, because only a natural person may own Subchapter S stock.[127] The result is that the corporation is taxed as a C corporation, and the corporation would be subject to the double tax regime of a C corporation. In regard to S corporations, generally, one of the primary reasons the shareholder(s) selected S corporation status is so that when the shareholder(s) sells the assets of the corporation such gain will be taxed as a capital gain and such gain will be subject

to one level of taxation. However, if the Subchapter S election was terminated and the corporation is taxed as a C corporation, in the event the assets of the corporation are sold,[128] the sale is subject to a double tax: once at the C corporation level and a second time when the proceeds of sale are distributed to the shareholder. The net effect of the corporation being subject to the double tax on sale of a C corporation is that the additional tax due as a result of the tax will be close to twenty to thirty percent of the sales price.

Annuities are another problem asset. One of the primary reasons a client purchases an annuity is to obtain the benefits of a tax deferral until distributions are received under the terms of the annuity contract. Under IRC § 72(u), only a natural person receives the tax deferral. While there is some indirect authority that an annuity may be held by a grantor trust,[129] an LLC that is classified as a partnership, of course, is neither a natural person nor a grantor trust. The result is that if an LLC that is classified as a partnership owns a tax deferred annuity, the tax deferral is terminated immediately.

In addition to the S corporation problem and the annuity problem, there are uncertainties with regard to both mortgage interest and the exclusion of gain on the sale of a principal residence. Is an entity that is classified as a partnership for tax purposes allowed to exclude up to one-half a million dollars on the sale of the principal residence? Also, is an LLC that is classified as a partnership allowed to deduct mortgage interest on a personal residence?

Unfortunately, the authors are not aware of any authority indicating whether an entity will be able to deduct mortgage interest on a personal residence. In contrast, there appears to be some limited authority that in certain circumstances the partner of a partnership may be eligible for the one-half million dollar exclusion on the sale of a principal residence owned by the partnership.

In IRS Letter Ruling 200004022, in the following circumstances the Internal Revenue Service ruled that a personal residence that for some period of time within the two year period prior to the sale was owned by a partnership was eligible for the IRC § 121 exclusion:

- The personal residence did not generate any income;
- The personal residence was not used for any business purposes; and
- The client owned one hundred percent (100%) of the partnership either individually or through a grantor trust.

While a private letter ruling may not be relied upon by any taxpayer other than the taxpayer requesting such a ruling, one might take the position that there is at least some authority that the partner or member of an entity classified as a partnership for tax purposes may exclude up to one-half million dollars on the sale of a principal residence. On the other hand, it may be wiser for a different asset protection vehicle such as an offshore integrated estate planning trust to own such personal residence. Under Rev. Rul. 85-45, 1985-1 C.B. 1834, it has been well established for some time that the deemed owner of a grantor trust is entitled to the exclusion under IRC § 121.

As noted above, in contrast to the one-half million dollar exclusion on the sale of a principal residence, the authors are not aware of any authority that allows a partner or member of an entity that is classified as a partnership for U. S. tax purposes to deduct mortgage interest. IRC § 163(h)(3) refers to both acquisition indebtedness and home equity indebtedness with respect to any "qualified residence of the taxpayer." A literal reading of IRC § 163(h)(3) makes one wonder how an FLP could possibly be the taxpayer and

live in a qualified residence. Only a natural person can reside in a personal residence for purposes of IRC § 121. Therefore, the Internal Revenue Service may have a strong position to claim that a partner of a partnership may not deduct mortgage interest under IRC § 163(h)(3).

While at present there is a small amount of ambiguity under IRC §721(c) in regard to whether gain would be recognized on the transfer of appreciated assets into an offshore LLC, it appears that this issue will be resolved in favor of the taxpayer. On the other hand, if the offshore LLC owns a partnership interest in any domestic partnership (or a domestic LLC that is classified as a partnership for tax purposes), the domestic partnership must meet the withholding requirements of IRC §1446. Further, as discussed above, there are significant adverse tax consequences if Subchapter S stock, annuities, or a personal residence are contributed to an offshore LLC that is classified as a partnership for tax purposes. If such assets are left outside of the offshore LLC, they must be protected with another type of asset protection vehicle. Otherwise, such assets will be left available and subject to creditor attack. In this respect, if an offshore LLC is classified as a partnership, it is not a comprehensive asset protection vehicle by itself.

D. Single Member LLC

All of the aforementioned tax problems may be solved by utilizing a single member LLC.[130] Under Treas. Reg. §301.7701-3, a wholly owned offshore LLC may "check the box" so it is taxed as a nonentity for tax purposes. Assuming the client is an individual and a U.S. citizen, the single member LLC would be disregarded for tax purposes and taxed as if such assets were owned by the U.S. citizen directly. A U.S. citizen is not subject to partnership taxation, and therefore, none of the aforementioned tax problems would apply in regard to a single member LLC that has elected to be taxed as a non-entity and is owned by the U.S. citizen.[131]

ENDNOTES

1. While Alaska, Delaware, Nevada, and Rhode Island have all passed asset protection trust legislation, it is uncertain whether such legislation would withstand creditor attacks as a result of the Full Faith and Credit Clause, the Supremacy Clause, and subject matter jurisdiction claims. For a further analysis of these issues as well as other comparisons between domestic and offshore asset protection solutions, see Asset Protection Planning: Offshore and Domestic Strategies, Chapter 10, published by Commerce Clearing House.
2. Revised Uniform Limited Partnership Act (RULPA), sections 702 and 703, and *Evans v. Galardi*, 546 P. 2nd 313 (Ca. 1976).
3. Please see chart detailing sole remedy states and states that have allowed the judicial foreclosure sale of a limited partnership interest.
4. *Rothwell v. Fertman*, D. Ct. Colo., Civil Action 92 Z 1881, Order Re Motion and Application to Charge Partnership Property (1994).
5. This may well be the case when at least one partner with a significant partnership interest is also a partner of the partnership. However, it may not be the case when it is the client and the client's spouse as the only partners.
6. In certain cases, certain domestic assets such as closely held stock in an S corporation may also be problematic. Please note S corp. stock could only be held by a single member LLC.
7. While the decision was reversed by the Supreme Court of California, both the trial court and the appellate court held that if the same creditors had the same judgments against all of the partners of the same partnership, the creditors could reach the assets of the partnership. *Evans v. El Dorado Improvement Co.*, 119 Cal. Rpts. 889 (1975). Please note that the same argument could easily be made in regard to a single member LLC that merely has checked the box as a nonentity for tax purposes. Further, some commentators have noted that a judge may decide to implement a nonbusiness purpose exception to charging order protection. The original purpose legislatures passed charging order protection was to prevent creditors from unemploying employees of operating businesses conducted through partnerships. Charging order protection was probably never intended to be an asset protection vehicle to protect investment assets.
8. Ala. Code § 10-9A-122.
9. Ala. Code § 10-12-35.
10. Alaska Stat. § 32.11.340.
11. Alaska Stat. § 10.50.380.
12. Ariz. Rev. Stat. § 29-341.

13. Ariz. Rev. Stat. §29-655.
14. *Bobonus v. Amerco,* 602 P.2d 469 (Ariz. Ct. App. 1979).
15. Ark. Code Ann. § 4-43-703.
16. Ark. Code Ann. § 4-32-705.
17. Cal. Corp. Code § 15673.
18. Cal. Corp. Code § 17302.
19. *Hellman v. Anderson,* 233 Cal. App. 3d 840 (1991); *Centurion Corp. v. CrokerNat. Bank, 208* Cal. App. 3d 1, 255 Cal. Rptr. 794, 796-797 (Ct. App. 1989).
20. Colo. Rev. Stat. § 7-62-703.
21. Colo. Rev. Stat. § 7-80-703.
22. Colo. Rev. Stat. § 7-80-703.
23. Conn. Gen. Stat. § 34-30.
24. Conn. Gen. Stat. § 34-171.
25. *Madison Hills Limited Partnership II v. Madison Hills, Inc.,* 644 A. 2d 363 (Conn. App. Ct. 1994).
26. Del. Code Ann. tit. 6, § 17-703.
27. Del. Code Ann. tit. 6, § 18-703.
28. D.C. Code Ann. § 41-475.
29. D.C. Code Ann. § 29-1338.
30. Fla. Stat. Ann. § 620.153.
31. Fla. Stat. Ann. § 608.433.
32. Ga. Code Ann. § 14-9-703.
33. Ga. Code Ann. § 14-11-504.
34. *Nigri v. Lotz,* 453 S.E. 2d 780 (Ga. Ct. App. 1995).
35. Haw. Rev. Stat. § 425D-703.
36. Haw. Rev. Stat. § 428-504.
37. Haw. Rev. Stat. § 428-504.
38. Idaho Code § 53-241.
39. Idaho Code § 53-637.
40. 805 Ill. Comp. Stat. 210/703.
41. 805 Ill. Comp. Stat. 180/30-20.
42. 805 Ill. Comp. Stat. 180/30-20.
43. Ind. Code § 23-16-8-3.
44. Ind. Code § 23-18-6-7.
45. Iowa Code § 487.703.
46. Iowa Code § 490A.904.
47. Kan. Stat. Ann. § 56-la4O3.
48. Ky. Rev. Stat. Ann. § 362.481.
49. Ky. Rev. Stat. Ann. § 275.260.
50. La. Rev. Stat. Ann. § 1331.
51. Me. Rev. Stat. Ann. tit. 31, § 473.
52. Me. Rev. Stat. Ann. tit. 31, § 686.
53. Md. Code Ann., Corps. & Ass'ns § 10-705.
54. Md. Code Ann., Corps. & Ass'ns § 4A-607.
55. *Lauer Construction, Inc. v. Claude Schrift,* 716 A.2d 1096 (Md. Ct. Spec. App. 1998).
56. Mass. Gen. Laws ch 109, § 41.
57. Mass. Gen. Laws ch 156C, § 40.
58. Mich. Comp. Laws § 449.1703.
59. Mich. Comp. Laws § 450.4507.
60. Minn. Stat. § 322A.57.
61. Minn. Stat. § 322B.32.
62. Miss. Code Ann. § 79-14-703.
63. Miss. Code Ann. § 79-29-703.
64. Mo. Rev. Stat. § 359.421.
65. Mo. Rev. Stat. § 347.119.
66. *Beutsch v. Wolf,* No. ED74743, 1999 Mo. App. LEXIS 1964 (1999).
67. Mont. Code Ann. § 35-12-1103.
68. Mont. Code Ann. § 35-8-705.
69. Neb. Rev. Stat. § 67-273.
70. Nev. Rev. Stat. § 88.535.
71. Nev. Rev. Stat. § 86.401.
72. N.H. Rev. Stat. Ann. § 304-B:41.
73. N.H. Rev. Stat. Ann. § 304-C:47.
74. *Baybank v. Catamount Construction, Inc.,* 693 A.2d 1163 (N.H., 1997).
75. N.J. Stat. Ann. § 42:2A-48.
76. N.J. Stat. Ann. § 42:2B-45.
77. N.M. Stat. Ann. § 54-2-42.
78. N.M. Stat. Ann. § 53-19-35.
79. *In re Priestley,* 93 B.R. 253 (D.N.M. 1988).
80. N.Y. Partnership Law § 111.
81. N.Y. L.L.C. Law § 607.
82. N.C. Gen. Stat. § 59-703.
83. N.C. Gen. Stat. § 57C-5-03.
84. N.D. Cent. Code § 45-10.1-44.
85. N.D. Cent. Code § 10-32-34.
86. *Farmes State Bank & Trust Co. v. Mikesell,* 554 N.E.2d 900 (Ohio App. 2 Dist. 1988).
87. Ohio Rev. Code Ann. § 1705.19.
88. Okla. Stat. tit. 54, § 342.
89. Okla. Stat. tit. 18, § 2034.
90. Or. Rev. Stat. § 70.295.
91. Or. Rev. Stat. § 63.259.
92. Pa. Stat. Ann. tit. 15, § 8563.
93. *Auburn Steel Company, Inc. v. American Steel Engineering Co.,* No.91-5747, 1993 U.S. Dist. 8971 at 4 (ED PA 1993).
94. R.I. Gen. Laws § 7-13-41.
95. R.I. Gen. Laws § 7-16-37.
96. S.C. Code Ann. § 33-42-1230.
97. S.C. Code Ann. § 33-44-504.
98. S.C. Code Ann. § 33-44-504.
99. S.D. Codified Laws § 48-7-703.
100. S.D. Codified Laws § 47-34A-504.
101. S.D. Codified Laws § 47-34A-504.
102. Tenn. Code Ann. § 61-2-703.

103. Tenn. Code Ann. § 48-218-105.
104. Tex. Rev. Civ. Stat. Ann. art. 6132a-I.
105. Tex. Rev. Civ. Stat. Ann. art. 1528n.
106. *Equitable Trust v. Roland*, 644 S.W.2d 46 (Tex. Ct. App. 1982).
107. Utah Code Ann. § 48-2a-703.
108. Utah Code Ann. § 48-2b-131.
109. Vt. Stat. Ann. tit. II, § 1412.
110. Vt. Stat. Ann. tit. II, § 3074.
111. Vt. Stat. Ann. tit. II, § 3074.
112. Va. Code Ann. § 50-73.46.
113. Va. Code Ann. §13.1-1041.1.(4)(b).
114. Va. Code Ann. § 13.1-1041.1.(4)(b).
115. Wash. Rev. Code § 25.10.410.
116. Wash. Rev. Code § 25.15.255.
117. W. Va. Code § 47-9-41.
118. W. Va. Code § 3 IB-5-504.
119. W. Va. Code § 3 1B-5-504.
120. Wis. Stat. § 179.63.
121. Wis. Stat. § 183.0705.
122. Wyo. Stat. Ann. § 17-14-803.
123. See, e.g., Isle of Man Limited Liability Company Ordinance 1995, section 43(l).
124. See Neufeld, David, "Chinks in the Armor—Piercing the LLC Veil and Other Exposures of Members for LLC Obligations."
125. IRC §864(b)(2)(ii).
126. Under Treas. Reg. §301.7701-3, the default rule if an offshore LLC does not check the box is that it is taxed as a corporation. In the event that more than fifty percent (50%) of the foreign corporation is owned by ten percent or greater U.S. shareholders, which is the most likely case, for tax purposes, the foreign corporation would be classified as a controlled foreign corporation ("CFC").
127. IRC §1361(b)(1)(B). Certain trusts are also permissible S corporation shareholders pursuant to IRC Section 1361(c), but partnerships have never been permissible as S corporation shareholders.
128. It should be noted that in almost all circumstances, a purchaser of a closely held business will demand to purchase the assets of the business, rather than the stock. A purchaser who purchases assets is able to generate a tax deduction by depreciating the assets. A purchaser who purchases stock is not able to depreciate the stock. Further, a purchaser of assets will be able to avoid any contingent liabilities of the corporation.
129. PLR 9204010 and PLR 9204014.
130. It should be noted that some states impose significant limitations in regard to the taxation of single member LLCS. For example, both Texas and Tennessee impose a franchise tax on the assets owned by a single member LLC. Therefore, state law also needs to be checked before selecting the single member LLC option.
131. It should be noted that some authors have taken the position that a single member LLC will be more subject to creditor attack than a multiple member LLC. These authors take the position that a judge would be more likely to disregard a single member LLC. On the other hand, other authors counter this argument with the statement that if this were the case, U.S. judges would be more likely to disregard a single member corporation. These authors stress that the entity formalities must be observed whether the entity is a single or multiple member LLC.