Using Offshore LLCs for Advanced Structuring of Management Companies

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Of all the considerations that must be made when formulating an asset protection program, one of the often overlooked and arguably most critical factors (aside from fraudulent transfer considerations) is management structure. Although a properly structured onshore management entity can certainly enhance any asset protection program, using an offshore company offers some unique benefits that cannot be achieved any other way.

There are two threats to a manager that can be avoided by using an offshore LLC or other limited liability entity. This first threat is that, if the entity is sued, the entity's manager can be added as a co-defendant on the lawsuit, if the plaintiff's attorney alleges that the manager acted in bad faith or was guilty of gross negligence (which most attorneys will do, if they can.) This is the exact reason why insurance companies now offer director's insurance to corporate officers and other upper-level management personnel. The second threat is that if the manager is within the jurisdiction of a U.S. judge, the judge may order the manager to do something that would compromise the debtor's asset protection program. For example, a judge could order the manager of an LLC to make distributions of profit to the LLC members, so that a creditor who is assigned a charging order interest may collect the profit that would normally go to a member-debtor.

Using a domestic LLC or corporation to manage the entity that holds assets provides an extra layer of protection. This is because, if an entity is sued, then the entity manager, if it is named as a co-defendant on the suit, will be another limited liability entity. The managers of the managing entity will only be named on the lawsuit if the limited liability veil of the managing entity is pierced. However, if the limited liability entity is pierced, then the people who manage that entity may be personally pursued for the judgment debt if the lawsuit is successful. Furthermore, if the managing entity is domestic, then it will fall within the jurisdiction of a federal or state judge. The worst case scenario is that the judge will order the dissolution of the domestic management entity. Unfortunately, the bottom line is no amount of domestic structuring can completely insulate the management entity from the risk that a judge may order its dissolution, or order it to do something detrimental to the debtor. It would be an admittedly rare and unique situation in which a judge would take such drastic measures as those we've described, however since such events are a real possibility, high-net worth individuals should strongly consider using an offshore entity for managing their asset protection structure.

A properly structured offshore management company would avoid both of the aforementioned dilemmas a domestic LLC might face. The author specifically recommends the Nevis LLC as a management company. Among other things, the Nevis Limited Liability Company Act is based upon the corresponding Delaware Act. Therefore, Nevis law integrates very well with U.S. law, which means its laws will be more familiar to a U.S. judge, and thus we can predict with much greater accuracy how a U.S. judge would interpret Nevis LLC law as opposed to the law governing some bizarre offshore hybrid entity that would be completely alien to him. Furthermore, although some

may think that using an offshore LLC would make management more difficult, this is not true. Although many offshore entities face complex and sometimes very punishing international tax laws (for example, an offshore partnership subject to U.S. taxation must withhold 30% of its income at the source and turn it over to the U.S. government[1]), an offshore LLC may elect to be taxed as an entity disregarded from its owner.[2] This means that the LLC has no requirement to file any entity level tax return. Rather, its taxable activity is treated as that of its owner, and reported on the owner's tax return.[3] Therefore a Nevis LLC may be structured so as to completely sidestep any tax return filing requirements altogether. Furthermore, even though the LLC is domiciled offshore, this LLC in turn may be managed by an onshore individual while the creditor seas are calm. When creditor threat arises, the Nevis LLC's onshore manager should be fired and replaced with an offshore manager. As long as the LLC's operating agreement is drafted correctly (which is absolutely critical!), all managing parties will now be outside of U.S. jurisdiction and thus not subject to a U.S. court order.

Using an Offshore Trust to Hold Offshore LLC Membership Interests

Although management is now wholly located outside U.S. jurisdiction, a clever creditor may convince a judge to order the onshore members of the offshore LLC to vote out the offshore manager and replace him with an onshore manager, who would be subject to the court. We can counter this problem by having the LLC's membership interest wholly owned by an irrevocable offshore grantor trust. If the trustee has discretionary power to vote as the LLC's member and is also located offshore, then he would not be required to obey a U.S. judge's order, thus preventing replacement of the manager. By using a grantor trust, the trust is ignored for tax purposes, thus sidestepping tax law regarding offshore entities, and it will have no 1041 or other filing requirement. Instead, taxable trust activities are treated as that of the grantor's, and reported on his income tax returns.

In light of the Anderson case[4] and other landmark court decisions regarding offshore trusts, the author feels that an offshore trust should not be structured in a manner that might be frowned upon by a U.S. judge. In other words, it is preferable that the trust not be self-settled[5]. An ideal offshore trust could be, for example, a trust with the grantor's children as the beneficiaries. Because the offshore LLC need have no more than a 1% interest in the entity it manages, its member distributions would be minimal. These distributions could be reduced even further if the onshore manager charged the offshore LLC a management fee for his services.

The figure below illustrates the structure we've discussed.

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[1] See Title 26 U.S.C. §1441(a).

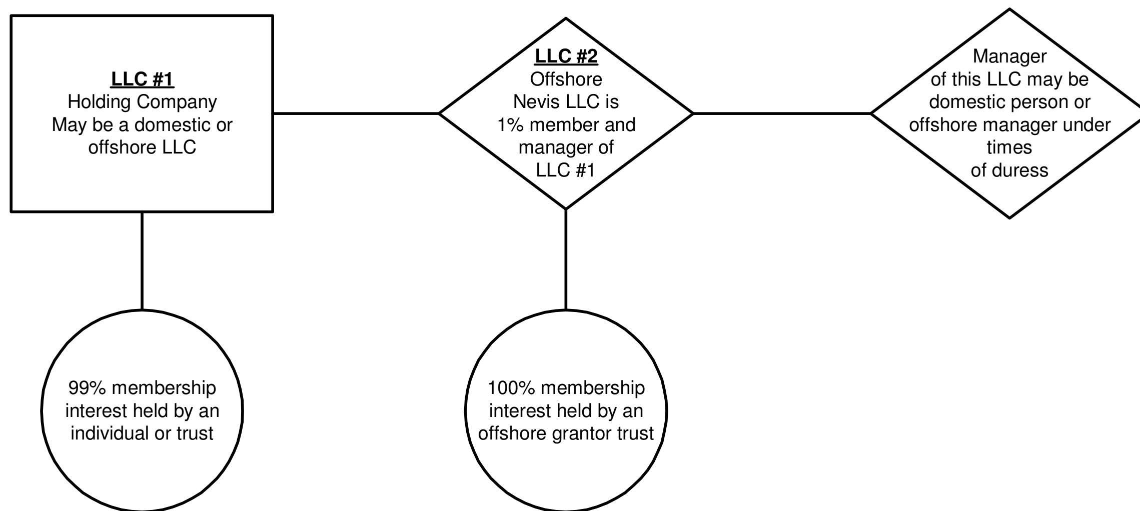
[2] This is accomplished by filing IRS form 8832.

[3] In the case of a natural person, the LLC's income would be reported on the owner's 1040 schedule C return.

[4] FTC v. Affordable Media, LLC, 179 F.3d 1228 (9th Cir. 1999.)

[5] A self-settled trust is a trust wherein the grantor is also a trust beneficiary. Currently, 46 of the 50 states have some sort of statute that specifies that, to the extent a grantor is also a beneficiary, his beneficial interest shall be freely attachable by creditors. This usually means a creditor may also directly invade the trust's corpus (property), spendthrift provision notwithstanding.

FIGURE 1



Offshore LLC and Offshore Trust Reporting Requirements

Because the offshore trust and LLC in Figure 1 is structured so as to be tax neutral, reporting requirements are reduced. However, some reporting requirements still exist.

- To elect disregarded entity tax treatment, the offshore LLC must file IRS form 8832. *Failure to file form 8832 will subject all LLC income to a 30% withholding requirement*, so it is very important to make a timely election. This form *will* require the disclosure of the LLC's owner for tax purposes. Also, any person liable for income derived from LLC profits should report their income on their 1040 schedule C return. If the offshore LLC does not receive taxable income, however, then there need be no return filed for the LLC, and there are no other reporting requirements for the LLC.
- Notwithstanding the above, any U.S. citizen who is a signer on or holds an interest in an offshore financial account(s) that holds $10,000 or more in the aggregate should mark "YES" on line 7a of your 1040 Schedule B return, and you should also file form TD F 90-22.1.
- Any U.S. citizen who receives a distribution from, or is either a grantor of or transferor to a foreign trust should mark "YES" on line 8 of your 1040 Schedule B return, and you should also file IRS form 3520.
- A common misconception is that if a U.S. citizen has earnings offshore, then it is not taxable. The truth is that whether earnings are onshore or offshore does not alter one's tax liability. If you would have tax liability from onshore earnings, then these same earnings would be taxable if they were earned offshore as well.

Can a Structure With No Reporting Requirements Be Formed to Receive Offshore Funds?

The short answer is yes. However, increased privacy and exemption from reporting requirements means you will have to sacrifice some of the asset protection fortifications that are found in Figure 1. Figure 1 is the strongest asset protection structure of all suggested arrangements in this article. Nonetheless two alternative structures, Figures 2A and 2B, are illustrated below for those who place a priority on legal privacy.

FIGURE 2A

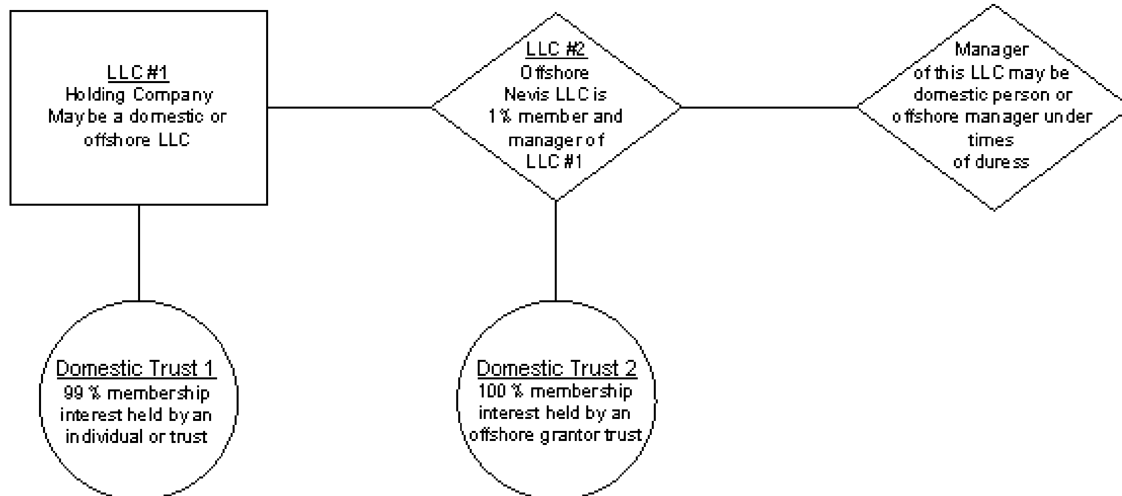
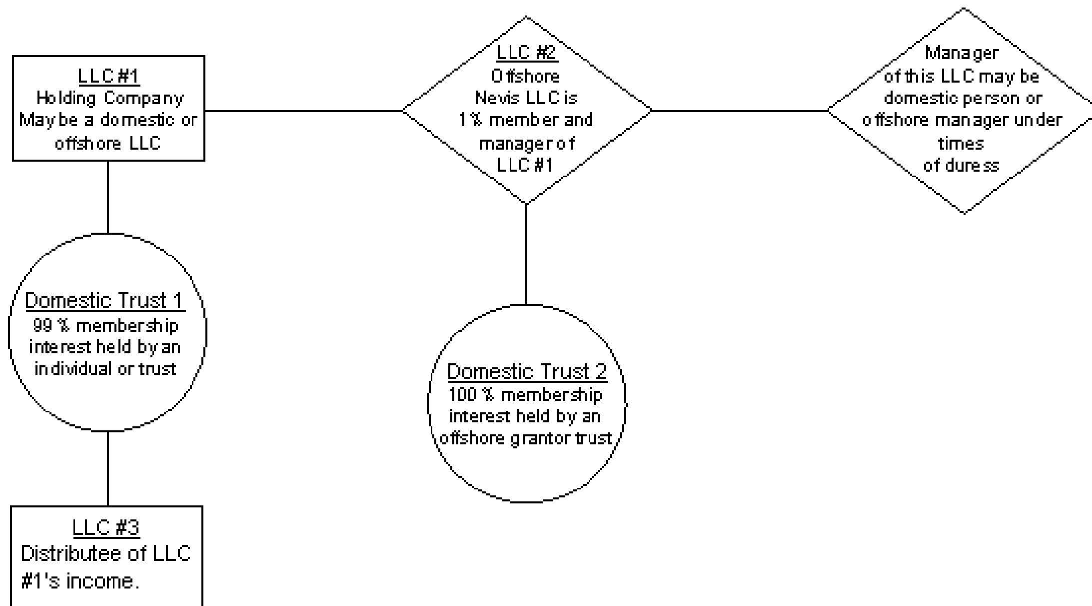


FIGURE 2B



Note that Figure 2A is a privacy-oriented structure designed to hold non-income producing assets, whereas Figure 2B is designed to hold income-producing assets. The main differences between these structures and Figure 1 are as follows:

- All trusts are domestic. This alleviates any IRS form 3520 reporting concerns.

    - In lieu of a domestic trust, a Private Panamanian Foundation that is classified as a 501(c)(3) non-profit organization may be used. Such a Foundation would give us the added asset protection benefits of an offshore trust without the extensive reporting requirements. However, Panamanian Foundations take more time, effort, and money to set up than an offshore trust. A Panamanian Foundation may also be used in lieu of the offshore trust in Figure 1.
- LLCs can be either onshore or offshore. Onshore LLCs have no entity-level reporting requirements if they are structured to receive the default tax classification of a disregarded entity. Offshore LLCs must file a form 8832 in order to receive disregarded entity tax status, however the information in this form is mostly non-invasive, although the LLC's owner and EIN# must be disclosed. The author feels that an onshore LLC as a holding company with an offshore LLC management company strikes a good balance between having a (mostly) private structure and a formidable asset protection program.
- Figure 2B adds a third LLC to the mix. This LLC receives almost all profit distributions from LLC #1. LLC #3 is necessary if the structure engages in activity that would subject the structure's ultimate beneficiary to income tax reporting requirements, and the ultimate beneficiary does not wish to have any paper-trail leading back to LLC #1, #2, or any of the trusts. When the ultimate beneficiary files his 1040 schedule C return, income is reported from LLC #3 instead from other entities in the structure. If an anonymous LLC is used, then there will be no record (except for private company documents) that connects LLC #3 to the other entities. Thus, the ultimate beneficiary is able to report income while legally obfuscating its source.
    - Figure 2B will not give maximum privacy if LLC #1 is subject to 1099 reporting. Therefore, although Figure 2B allows maximum privacy for a structure that engages in taxable activity, income producing activities will be somewhat restricted if maximum privacy is to be maintained.
- Figures 2A and 2B should also not hold any offshore bank accounts whose funds in the aggregate equal $10,000 or more. Otherwise, the form TD F 90-22.1 must be filed.