WILLMS, S.C.

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LAW FIRM

MEMORANDUM

TO: Clients and Friends of Willms, S.C.

FROM: Attorney Maureen L. O'Leary

DATE: April 21, 2011

RE: Should I Put My Primary Residence Into A Limited Liability Company?

Multiple member limited liability companies ("LLCs") can be very useful tools for achieving asset protection[1]. For this reason, individuals sometimes consider transferring their primary residence into an LLC. There is no law that says you can't put your primary residence into an LLC, but there are numerous reasons why it may not be a good idea if your primary objective is asset protection.

LLCs can provide two different levels of asset protection.

> **"Inside Liability Protection" -** If the *LLC* is sued, the person suing the LLC should only be able to reach the assets that are owned by the LLC. If the LLC was properly structured and maintained, your personal assets should not be available to satisfy the claims of the LLC's creditors.
>
> From this "inside liability" perspective, transferring your primary residence to the LLC is a bad idea because if the LLC is sued and the LLC owns your primary residence, the residence will be available to satisfy the LLC's debts and liabilities.
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> **"Outside Liability Protection" -** If *you* are sued and you own an interest in an LLC, and if the LLC was properly structured and maintained, the person suing you should not be able to reach the assets within the LLC. Instead, the creditor should only be able to obtain a "charging order" against your interest in the LLC. A charging order assigns some of your rights in the LLC to the creditor. For example, if the LLC makes a distribution to you, the creditor would be entitled to that distribution. However, this may not be appealing to a creditor because if a charging order was obtained, the LLC's manager might choose to not make distributions (if this was

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[1] Single member LLCs do not provide significant asset protection (and LLCs owned exclusively by a husband and a wife are often considered a single member LLC). Therefore, this article focuses exclusively on multiple member LLCs that are owned by two or more people that are not married to each other.

allowed by the company's operating documents). In addition, an LLC's tax liability flows through to its members. If a creditor obtains a charging order, your share of the LLC's income tax liability will arguably flow through to the creditor, which can be a disincentive for a creditor to obtain a charging order against the LLC in the first place.[2]

From this "outside liability" perspective, the idea of transferring your personal residence to an LLC might appear attractive. After all, if you are sued personally but your primary residence is owned by an LLC, it is possible that the creditor's only remedy would be a charging order against the LLC. However, before you transfer your primary residence into an LLC for this reason, be sure to consider the following.

Following is a summary of issues to consider before you transfer your primary residence to a LLC for the purpose of protecting your residence from the claims of your personal creditors.

1. **Is There a Business Purpose**? A LLC is a business and you need to have a business purpose for putting each asset into your LLC. You should not mix your personal and business assets in an LLC. Unless if you plan on paying rent to the LLC in exchange for your continued use of the residence, it is hard to argue that your primary residence is a business asset[3]. If you do not observe proper business formalities, a court could disregard the existence of the LLC. If the LLC is disregarded, you will lose the asset protection benefits of the LLC. If the LLC is sued, your personal assets could also be at risk, and if you are sued, the LLC's assets could also be at risk. Therefore, by putting your personal residence in your LLC, you could compromise the asset protection for your other personal and LLC assets.[4]

2. **Loss of Capital Gain Exclusion**. Section 121 of the Internal Revenue Code allows you to exclude up to $250,000 (if you're single) or $500,000 (if you're married) of capital gain when you sell your primary residence if you've lived in and owned your home for at least two of the previous five years. If you transfer your primary

[2] Depending upon the circumstances, commentators, academics, and practitioners disagree on whether a charging order should result in a debtor's share of an LLC's taxable income to flow through to the creditor holding the charging order. *THE CHARGING ORDER AND ESTATE PLANNING: AN OVERVIEW OF CHARGING ORDER PROTECTED ENTITIES AND THEIR POTENTIAL ROLE IN WEALTH PRESERVATION*, page 12, http://www.jeffreyburr.com/CM/Custom/Charging%20Order%20Article%2009-09-08.pdf.pdf.

[3] From an income tax perspective, we do not recommend paying rent to an LLC for use of your personal residence because it will result in taxable income to the LLC that will flow through to you and the other members and you will not receive an income tax deduction for your rental payments.

[4] "An entity or series of entities may not be created with no business purpose and personal assets transferred into them with no relationship to any business purpose, simply as a means of shielding them from creditors. Under such circumstances, the law views the entity as the alter ego of the individual debtor and will disregard it to prevent injustice." In re Turner, 335 B.R. 140 (Bkrpt. N.D. Cal 2005).

residence to a multiple member LLC, you lose the ability to benefit from this capital gain tax exclusion.[5]

3. **Loss of Property Tax and Mortgage Interest Deductions**. If you transfer your primary residence to an LLC, you will most likely no longer qualify for property tax and mortgage interest income tax deductions because you no longer own the property (so you can't take the deduction personally) and an LLC can only deduct ordinary and necessary business expenses (so the LLC can't take a deduction either). If there is no business purpose for the LLC to own your residence and you do not pay rent to the LLC, the LLC's expenses incurred to maintain the residence are not deductible.

4. **Real Estate Transfer Taxes**. Be aware of your state's real estate transfer tax rules. In Wisconsin, a $0.30 tax per $100 of a property's value must be paid to the Wisconsin Department of Revenue when you transfer real estate to a multiple member LLC, unless if the LLC's members are related to each other.[6] Another way to qualify for a transfer tax exemption in Wisconsin is to form the LLC with you as the sole initial member and then convert the LLC to a multiple member LLC after the real estate is transferred to the LLC.

5. **Loss of Homestead Exemption**. If you transfer your primary residence to a LLC, it will most likely lose its homestead classification. In some states, such as Florida, maintaining your homestead exemption is extremely important. The loss of your homestead exemption can result in increased property taxes and the loss of the benefit of homestead creditor protection laws.

6. **Mortgage Due on Transfer Clause**. If you have a mortgage on your residence and you transfer the residence to an LLC, it could trigger a due on transfer clause and result in your mortgage being immediately due and payable. However, this risk can be addressed by obtaining your mortgagor's consent in advance of the transfer.

Despite all of the above issues, it is possible that in certain circumstances you may achieve asset protection if your primary residence is owned by an LLC. There might also be other estate planning reasons why you want to put your residence in an LLC. However, before you transfer your primary residence to an LLC, please be sure to seriously consider all of the above potential consequences. In many situations there will be a better alternative.

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[5] CCM 200029046: The Office of Chief Counsel advised that where a taxpayer and his spouse formed a limited partnership with a family-owned LLC as the general partner to hold their personal residence, the taxpayers cannot exclude gain from its sale. Because the residence is owned by the partnership rather than the taxpayers, the taxpayers are not considered to have owned and used the property as their principal residence for a two-year period prior to sale.

[6] Wis. Stat. 77.25(15s). Please be sure to carefully review the relationship requirements in this statute before relying upon the exemption. Please also note that trusts and/or businesses cannot be "related" to each within the meaning of this statute.

One alternative to consider if you're looking for asset protection is to retain an ownership interest in your residence for your lifetime (a "life estate"), but make a gift of the right to own your property after your death (the "remainder interest") to your children or an irrevocable trust. This should provide asset protection for the property because you no longer own 100% of the property. If a creditor were to sue you, they could potentially pursue your life estate, but they should not be able to reach the entire property, which acts as a deterrent to many creditors.

This technique can avoid many of the problems that could result from transferring your property to an LLC because you are still considered the owner of the property for your lifetime. However, in order to qualify for the entire $250,000 or $500,000 capital gains exclusion upon the sale of the house during your lifetime, the remainder interest must be transferred to an irrevocable trust that is considered a "grantor trust" for income tax purposes.

It is important to understand that the gift of a remainder interest is irrevocable and if you want to sell the property during your lifetime, it will require the consent of the remainder beneficiaries. If you sell the property with the consent of the remainder beneficiaries, the remainder beneficiaries are entitled to their share of the sales proceeds (or you can all agree to reinvest in a new residence).

Please let us know if you have any questions regarding the topics in this memo or if you would like our assistance with any asset protection planning techniques.

<u>END OF MEMO</u>