Tax Ramifications of a Disregarded Entity

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TOPIC: Mr. Mathis will discuss the tax ramifications of a disregarded entity, what constitutes a disregarded entity, the dangers of being misclassified, and how they can be used to your advantage.

For example: If an LLC has only one member and is classified as an entity disregarded as separate from its owner, its income, deductions, gains, losses, and credits are reported on the owner's income tax return.

An individual owner of a single-member LLC classified as a disregarded entity is not an employee of the LLC. Instead, the owner is subject to tax on the net earnings from self-employment of the LLC which is treated in the same manner as a sole-proprietorship.

START

Welcome to Tax Ramifications of a Disregarded Entity. My name is Toby Mathis and I'm going to be your presenter tonight. We're going to be talking pretty much about, well you'll see, LLC's, QSubs, entities that we choose to disregard for tax purposes. Why they're used. How they're used. I'm going to give you a lot of... a little bit of some examples of common uses of disregarded entities. Before we get there, I'm just going over just some basic housekeeping matters.

The first of which is if you have questions on the page that you are viewing this on. It should read the "Tax Ramifications Of A Disregarded Entity" right up top and it should have my picture there along with the broadcast. If you scroll down below that you will see the... what does it say? Leave a reply. Where it asks for your name and email. Go ahead and ask your questions through that mechanism. Do not respond to the live chat. There will be a pop-up where one of our representatives is engaging you if you have questions. That we cannot see during the webinar. I want to make sure that you use the 'leave a reply' feature. Your question will be viewable by everybody else that is on the webcast so don't use specifics that could be harmful to you. If you ask a question, ask a general question. Don't put in personally identifiable information like social security numbers and things like that. I know that may seem like common sense but believe it or not we've had people do that. We'll erase it but still it's out there for a little while. If you have a private question, then wait till after. Use the web feature to ask questions. I'll give you at the end of the webinar the opportunity to contact me. I'll broadcast my email so you can shoot me a question if you have something that's very personal.

All right, let's jump right on in. What about Anderson? For those of you who've been our clients you know who we are. We have offices in Nevada and Washington. I oversee the Las Vegas office for Anderson Law Group and Business Advisers. We have well over 12,000 clients throughout the United States and throughout the world. Our attorneys are investors, which means we do what you do. We're business owners. Just about everybody invests in real estate, a lot of stock investors including our accountants, which we have a very active tax practice with CPAs, EAs, bookkeepers, and accountants. We handle thousands of returns every year and keep the PNL balance sheet on many, many, many businesses. Hundreds of businesses. We also have a financial planning component where we are very bullish on the 7702 plans, which is referring to an internal revenue code. That makes the receipt of funds out of certain plans non taxable and utilizing those as part of an overall plan is very beneficial to many of our clients.

As in most things, we also do it ourselves. I'm one of those guys who believe that if you don't do it, you shouldn't really be talking about it. Unless you've engaged in the activity, you probably shouldn't be teaching other people how to do it. It sounds redundant but many attorney, many an accountant that's exactly what they do. They don't actually engage in the activities that their clients do, but they try to give them advice on it. I call that ivory tower mentality. It's very tough. Whenever you're talking about planning, whether it be tax planning, asset protection planning, estate planning, knowing the difference between a taxable and non-taxable entity can easily spell the difference between success or failure. Meaning that a lot of well-intentioned accountants create structures that have such onerous tax compliance or tax ramifications that they literally undo any benefits that the plan was set out to accomplish. For example you hear people going off shore. You hear of people using irrevocable trust. These kind of new fangled instruments [inaudible

00:04:22] trust, things like that. The accountant doesn't understand the ramifications of what they're doing or they just flat out don't know. They go ahead and put things in place that impact their clients horribly.

For example, we've had folks come to us that have been working with IRA custodians that will have them engage in disqualifying transactions on small amounts saying, "Hey, it's not a big deal." It disqualifies the entire IRA amount. I've seen a half a million dollar IRA disqualified over a $50,000 transaction. The penalty on that alone before we even talk about the tax was over $50,000. You'll see that. We've also seen FBAR failures when somebody does some offshore planning and they fail to properly report that income. We've seen that. I saw $75 interest payment result in over a $30,000 penalty. Knowing the difference of when you have to report and when you don't have to report or creating things that don't have tax complexity is important. Knowing your options, this is where you come into play. A lot of times we're at the mercy of an accountant. Just knowing what your options are can have a pretty big impact on whether or not you engage in certain types of transactions with an accountant. Sometimes it's up to you to be able to put your accountant right in case their doing something odd.

Did You Know? Let's do some Q and A. Annually one in four people are involved in a lawsuit. I'd ask you to raise your hand and tell me whether or not you've ever been sued and whether you liked it but I can't see you so I'm not going to ask it. We'll do it as a hypothetical question. Whether anybody enjoys being involved in a lawsuit? The fact of the matter is right now there is a little bit of a lottery mentality. The verdicts are going up. The benefit for engaging in some unsavory activity is causing it to occur more often. Unfortunately that's not going away. The average judgement is 1.2 million versus average insurance coverage of about 500,000. Meaning that there's a shortfall there almost two to one when people are sued and we're going to talk about insurance and lawsuits here in a little bit.

The typical person, the average person, will be involved in five lawsuits during their lifetime. A lot of you guys have saved them up. You waited... and they comes in little groupings. If you are a small business owner and have employees and deal with any sizable business you know that you’ve to pick one up about one a year. If you don't have any money and you're not really engaged in any sort of business activities, you don't have to worry. Your chances are no ones going to see you.

That's not our clientele. Our clientele tends to be very active. It's important to understand what your options are and what needs to be protected.

What does need protection? Talk about your personal assets. How about your business assets or your savings? Stocks, bonds. These are the things that are easy. These are the low lying fruit. This is the stuff that's in our realm that's very easy. If you have an account with a million dollars, it's very easy to garnish it. It's very easy to get a writ of attachment against that. Then you have real estate. Those are things that actually they tend to create liability on each other. If they're all under one umbrella, it can be very detrimental to somebody. For those of you who have rentals you know what I mean. You have one bad thing go wrong on one rental and they start looking at all the others. Then businesses, if you're engaged in business to any extent, chances are you've had the joy of dealing with either employee lawsuits. Dealing with municipalities. Whether it be a city or a county or someone barking at you or slip and falls on people that have gone on to your property and maybe had an accident or other vendors or other clients or customers. It's just part of doing business. In fact many... I forgot... I think it was Mark Cuban [SP]. They asked, "What's the best part and what's the worst part of being a billionaire?" He says, "It's dealing with the lawyers and the lawsuit is the worse part."

What needs protection? All of it frankly. You need protection from your other activities so you can have peace of mind. Lawsuits to me is about 3 A.M. and 3 A.M. means that’s when you start thinking about all the arguments you're going to make and you wake up and you stare at the ceiling. I don't care whether you're a plaintiff or a defendant. The fact of the matter, it has an emotional toll and it's not a good emotional toll. What you want to be able to do is be objective about them. Treat them as a business transaction and get the emotion out of it because the emotion will have a very negative impact on you. It's kind of like if I walked up and put a gun to somebody's head and said, "Give all your money to me." I would be put away and put in jail. If I sue somebody and threaten to take all their money away, I can be rewarded for that behavior. Unfortunately our society is just built like that. I wish it wasn't but it is. Again if you've ever had this done, this is what it feels like. You're looking down the barrel of a large revolver. They're literally threatening to take everything you own.

What are the big threats that are out there? Well if you have real estate, you have tenants, environmental claims, personal injury. Obviously those are kind of the big ones. How about if you have children? They drive. They get into accidents. They do other things that cause you some consternation. Services as corporate officer. You can actually be a representative of a company and find yourself on the wrong side of a suit. A lot of folks think, "Well outside people can't really sue me." Well guess what? If you engage in activities as an employer or as a corporate officer and you have employees. They like to name you anyway. A lot of times they go away but it's still the emotional hassle. That's still a threat. Joint tenancy general partnerships. This is if you own assets with somebody else. All too often we hear bad stories of somebody who engages in business and they don't isolate the business through an entity. They're put on the hook when the partner runs off with all the money or it's found out that they've been embezzling or has obligated the company on huge liabilities without your knowledge. But you are a partner in that partnership and viola they come after you as one of the people. The fact of the matter is there's just too many attorneys out there. We're turning them out everyday. There's just a ton of them.

Why is there a problem? Because look this is the lottery mentality. A lot of folks believe this is how you're going to get rich. When you go in front of a jury of your peers, I can guarantee you is not a jury of your and my peers. It's a lot of folks that don't have anything else better to do or they're trying to do their civic duty. The majority... and I've clerked for three different judges. I've dealt with these folks. A lot of the people that really do the jury duty and that the attorneys are seeking are folks where they have an axe to grind. A good plaintiff lawyer, that's what they're looking for. It's extremely easy to get access to our legal system. In many states, depending on where you're at, the damages can be unlimited. California for example right now is having a serious issue. If you're an employer and you have employees, it's extremely easy to find yourself losing hundreds of thousands of dollars as a result of employer suit. For laws that you might not even be aware of and so it's just critical.

What else? Getting sued today for something that happened in the past. I had a client who was just on chain of title and I think it was over a decade prior and they got sued as being in the chain on someone that found an environmental issue many years later. Of course they just sued everybody that had ever owned the property.

What do you do about it? Well there's not a lot you can do about it. All you can do is try to isolate off some of your assets. Frankly there's just too many laws out there. How do you know them? I mean the Internal Revenue codes are over 20,000 pages of code. Not to mention millions of pages of tax laws. How are you supposed to know it? You're not. What you do is you minimize the risk so that you can walk away from things as cheap as possible. If you follow these three basic rules you'll find that things go away a lot quicker.

What we're talking about is settlement. The ability to force a quick resolution so that we don't incentivize somebody to turn up the pain to increase the amount of money that they can get out of you. At the end of the day, you want a good result is something that “hey I know and I can quantify the value of a claim.” For those of you who don't know the calculations that most lawyers use, it's going to be the value of the claim multiplied by the percentage of chance of getting it. If I have a $100,000 claim with a 70% chance of getting it. My claim is worth about $70,000. The next step is what are the chances of collecting that? If that's a 100% chance, which means I can see lots of assets, then some attorneys will use it to leverage that asset and make it even much more valuable.

Let me explain how that works. A plaintiff is considered the master of pleadings. When they sue, they have the choice to sue for causes of action. They may have causes of action that they don't even bring up because they don't believe they will collect on it or if they're dealing with insurance they believe it may be a claim that's not covered. The difference is if I look at a defendant and I can see they have lots of personal assets that are easy to attach, I may assert things against them that are not covered by insurance. In other words, I'm trying to go beyond the insurance policy so that I can get to their personal assets. Now the flip side to that is if they can't see what you own, then they may stay within the insurance policy simply because they want to make sure that they can get a collection. In other words, they don't want to go and have that insurance company defend you under reservation of rights. Saying, "Hey we may not cover it" because a jury may find that you engaged in intentional conduct when the insurance policy only covers negligence. They want to make sure they're going to collect so they're not going to plead. They're not going to plead in the complaint intentional misconduct. Even if it existed. They don't have to.

That's where it kind of comes into play when we're trying to force the settlement. You hopefully never get on the wrong side of a suit. If you did, you'll be very grateful if you follow these three basic rules. The three basic rules come down to: Do not own anything in your name. Do not do anything in your name. Frankly, don't own assets where you conduct businesses. In other words, if you have a business and you're a doctor, don't have $10 million of cash sitting in that practice. Don't have hundreds of thousands... get the cash out. That may sound easier said than done. You might be saying, "Oh Toby, you're just being tongue in cheek. Why are you saying that?" No it's not actually very difficult to move things out of your name. Especially with certain types of assets and that's what we're talking about tonight. We're going to be talking about doing some weighing and doing some tests.

When we engage in planning is this something that everybody can do? Yes. There's folks out there who say play one key on the keyboard. You go into your accountant and they're always saying, "S Corp. S Corp. S Corp." There's no such thing as one size fits all. That's a horrible picture. I think I see Michael Bowman at the front there. The idea is that there is no such thing as one size fits all. Everybody's a little different. I'll remove that. Have solutions. Remove your name from ownership by moving an asset into an entity. This is a very personal situation. This is things where you look at the asset and depending on the type of assets is going to dictate what type of entity maybe it gets moved into. I'm going to give you guys a ton of examples towards the end of this presentation where I'm going to show you things that may be free. Don't even cost you anything. But can accomplish this.

We don't want to look like this guy. A rich oil dude with a cigar. He's a very attractive target. I want to sue him just because I'm looking at him and don't like him. We want to look like this guy. He's got nothing in his pockets. We want to look like the guy that says, "Oh, you know what? Maybe we should just settle." Whenever you're doing any sort of planning, we're going to weigh the benefits. We want to remove your name from ownership by moving the asset to an entity. At the same time, we don't want to just do it willy-nilly. We want to do it by weighing the benefits.

Let's say you go to your accountant or adviser or attorney and you say, "Hey, I'm interested in asset protection." They're going to come at you and if they're not up on it, they're down on it. They need a check up from the neck up. Right? They've got some stinking thinking that they're going to inflict on you. Because again we tend to be a product of what we've been taught. About 85% of us follow whatever our parents said and so if they said, "Money doesn't grow on," fill in the blank, "Trees." Then we tend to hold that view. In the financial industry, they're always going to tell you what's easy for them which is, "Hey keep everything in your name." With asset protection that does not work. With estate planning that does not work. More importantly with tax planning doesn't work.

What we do is we weigh the benefits. If you find that you have a Negative Nelly accountant or adviser, I'm going to give you the responses to their arguments. We're going to say, "Hey, we want to shield some assets. I was listening to this lawyer online. This guy Toby with Anderson Law Group. He starts talking about taking assets and getting them out of my name. So people can't just take them from me." The first thing they say is, "It costs too much." The next thing they say is, "But the tax compliance is a nightmare." Then they say, "But you've never been sued. Why would we worry about it?" Then they're going to say, "Hey you should just buy insurance and use a big umbrella policy." Does that sound familiar? Does that sound familiar to any of you guys? Probably. Let's go down these ones one by one.

It costs too much. "Hey your house doesn't have enough belongings in it to have an alarm." Do they ever say that? You think they would ever say that? It's not worth enough. You don't have enough stuff. You don't need a camera for your family because frankly they're not worth anything. Is that what they're telling you? Because I'll tell you what, I have clients where the $100,000 home that they have. The rental is far more important to them than another client who may have a million dollar home. The accountant would say, "Oh, absolutely we should put the building into an LLC. Absolutely." To the $100,000 house? "It's not worth enough." Are you kidding me? It's probably more important. It just costs too much. What do you mean it costs too much? They'll say, "Hey just go ahead and get an umbrella policy." They're obviously not crunching the numbers. This is the average cost of umbrella policies in the United States. This was an industry report. I think it was called Ace that did the report. It's showing that for a $1 million dollars coverage in a household with one home, two cars, and two drivers, the average umbrella cost is about $383 a year. They're going to tell you to do that. In fact I had one client they said, "Get $3 million in coverage." Okay so it's 400 or 500 bucks. I'm not going to tell you not to have umbrella. I have umbrella. I keep a basic $1 million policy which covers you in case you have liabilities that exceed your car or your homeowners policies. I'm certainly not going to say this is a replacement vehicle. Especially when you look at... for example state filing fees on an LLC is average of about $150 per year.

If I can protect an asset and I can make sure that no matter what they can't come take everything else I own. They cannot garnish my wages. I'll give you a great example. Client has a good W2 job and they buy a rental. They have a slip and fall on that rental. The amount of judgement far exceeds the liability insurance. They can garnish that client's W2 income for the rest of that's client life. It doesn't go away. You can try to bankrupt some of those debts but a lot of them are non dischargeable. Just for your information 13% of jury awards exceed $1 million. Let's go back to our Negative Nelly and their great example of, "Hey, it costs too much to do an LLC." Are you kidding me? We've had accountants literally tell clients don't worry about putting your commercial building in an LLC. This was before lenders basically required it. This was going back 15, 20 years. I still remember and I said to the client, "Great have that accountant just sign off and say that they'll cover the liabilities if they exceed the cost of the property." We had a client that came into us too late to receive that kind of advice and she lost 15 pieces of property because of a wrongful death on a commercial building. When they foreclosed, even though the values of these buildings was far in excess of what the judgement should have been, the cost of foreclosing and then the amount that they actually received at the foreclosure sales was such a disparity that they ended up foreclosing on every single property.

In other words you may have a building that's worth $2 million but if it's sold at a foreclosure sale, it may get 1.2. Then the cost of actually going through that they get to tack on that as well. Usually you have that first, the person who has the loan on it coming in and buying it for whatever the loan was. It just basically drives me nutty. I say, "Hey we can absolutely lock away this liability and we can get some tax benefit. And on top of that, we can also avoid probate and do some estate planning." Again these guys that play one key or Negative Nelly's, they'll go out there and tell you not to do something. I just say, "Hey, if they're going to give that advice, put it in writing." Agree to indemnify me if their advice cost me. Because guess what? There's a very good chance that if something happens that you're going to be looking at money out of your pocket. I would just say, "Hey we could cut that down and we could eliminate that risk for not a lot."

How about the tax compliance? “Oh, it costs too much.” Well we're talking about disregarded entities folks. We're talking about things that don't actually have any tax compliance. In other words we're going to be talking about things that don't have tax returns. They don't require a lot of elbow grease. Where's that argument now? Hey Negative Nelly, what about that? It doesn't cost anything. Well they'll probably think of something else. You're killing trees with the paper that will probably come up. How about this? I've never been sued. Well I've never been a lot of things... (audio skips) I've never been in a major car accident. There's a lot of things I've never... it doesn't mean it's not going to happen. For all you single people out there that have never been married, you’ve never been married. That doesn't mean you're not going to. If you're young and you haven't had kids, it doesn't mean you're not going to. They use these weird arguments of, "Well you've gone 10 years. You've never been sued." Actually your chances are even that more likely that you're going to get to experience it. Like I said some people save up.

Now I'm going to talk about something that is very emotional. Because for those of you who have been paying attention to the news for the last ten years, you know that there's been a lot of tragedies out there. One of the big ones was Hurricane Katrina. We've had wildfires. We've had some pretty significant occurrences. A lot of these same advisers said, "Hey carry your insurance. Pay off your house." Buy insurance. Pay off your house. I don't know if anybody's been paying attention to it but there's still a lot of empty lots down there. In Mississippi, Louisiana, and some California areas where they had the wildfires. And Texas. Lots of different places where insurance was playing games. They were denying coverage. People who did not have somebody else that was an advocate. In many cases I tell people to carry an HELOC or home equity line of credit on your house. Even if you don't need it. It doesn't cost you anything. Maybe it costs you 50 bucks a year. If something bad happens you access that HELOC and then you have a bank now on your side. What happened in Katrina is a lot of folks didn't have flood insurance. It wasn't the flood that destroyed their homes. It was the wind damage. It was the storm damage. It was the hurricane that knocked it over. The insurance company would say, "Oh, there's an exclusion for flood. We're not going to cover it." Okay go ahead and pick that battle with the insurance company. I hope you have a $100,000 cash lying around to burn. You got to make sure that you're listening to good advice and that your making decisions that are in your benefit and your best interests as opposed to something that's convenient by somebody else.

When I teach events a lot of times I show a slide of a hot air balloon. There was a guy that got blown way off course in a hot air balloon because of a storm. Didn't know where he was and he saw somebody in the field and he lowered himself down in the field and he called down to the person. He said, "Hey, do you know where I am?" The guy in the field looked up and said, "Yeah. You're in a hot air balloon." Absolutely accurate. Absolutely useless. Unfortunately with a lot of advisers is they're very enamored at the fact that they can give useless advice. When you are talking to somebody about asset protection the job of that person is to protect you. Not make their life easy. Their job is to protect you. Not make them rich. Which a lot of advisers do is they create work for themselves.

At the end of the day here are some things that you can do. Buying insurance, I'm not going to tell you not to do it. But I'm going to say if you rely on it, there are a ton of situations where insurance claims were denied through exclusions. For example black mold. For example flood damage. For example wildfires. Acts of God. Things like that. Where the policy is not going to cover you. Read your exclusions. The other big one is they get the policy. They get the application. They try to find anything that wasn't accurate when you made representations under oath to them about your financial situation. Sometimes they will nail you on credit. They will deny you saying, "Hey you've made misrepresentations." If they had known certain things and they would have written the policies and they deny the policy there and then you're picking a fight.

Now when I said I clerked for three judges. I sat through a trial where somebody who had a fire that burned down their home had the joy of fighting with an insurance company for three years before they paid up. You don't want to rely just on that. I want to minimize my liability. I want to have a certain amount of certainty. Then you can stand out in the crowd. You can be that non Negative Nelly. You can be a Positive Peter or whatever they call it. You can be the happy ball with all the other blue ones rolling around. When I was in Seattle, which I lived for 25 years or there about. I lived up on Finny Ridge and I looked down over the fisherman's terminal. If you've ever watched Deadliest Catch you guys know the boats. That's where the boats tend to be docked is down there on fisherman's terminal. Yu see these crab boats and they have these big stainless steel tables that have sides that are about two inches. Then they also, a lot of them if they're going dungeness crab hunting will have just a box on top. The boxes don't have lids and those tables don't have lids. You know why they don't have lids? Because the crabs don't let each other off the table and don't let each other out of the box. Do you have any crabs in your life? That are pulling you back into your box? Get out of the box. Think outside of the box.

If you listen to some of these guys this is going to be your protection plan. You're exposed. Not so good. You get t-boned. But I never been t-boned. You get t-boned. But I got good insurance. You're as good as dead. What we want to do is have... and there's our entity setup, you want to have something that's pretty sturdy and is going to protect you. The way you do it is through entities. That's your last line of defense. There's tools and they're very specific tools for different things. Why do we have entities? Well they came out way back when. Remember the East India company? We're talking about spice trading. People traveling across the Atlantic. All over the world going throughout the Mediterranean and these boats would sometimes do something that's called sinking. Where they would actually go down and some people would lose their lives. If you were an investor in this and you were one of the owners, you could lose everything if you didn't have some stop gap of where it said, "Hey this is the total amount of money you could lose." What if you invested in the stock market and instead of just losing your investment they said, "Hey, we can come take your retirement plan. We can take everything you can own. By the way we're going to garnish your wages the rest of your life." Are you going to invest in things? No way. And so that's where entities came up and that's to protect you.

We had this little fiction. What is an entity? A person, partnership, organization, or a business that has a legally and separately identifiable existence. I just grabbed that one off of a business dictionary. But it sounds good. What it means is you have an artificial person. That's what the Supreme Court has looked at it. They said "Hey it's either corporations, limited liability companies, pensions, limited partnerships." These are all examples of artificial people or entities. They can have a separate existence for you. They can be sued. They can engage in contracts. More importantly they can isolate the liability so that you are not sued for their acts and vice versa. In other words think of how weird it was that if you had a neighbor that if your neighbor did something that you could be sued. That doesn't seem very equitable. Here you can create a legal fiction. You can create a corporation that becomes your neighbor. It's a separate entity. It's an artificial person. If it does something goofy you should not have to pay the price personally. You may lose your investment. But that's your risk. Limited liability company's a great example. They came about and a lot of times they're used solely to eliminate liability.

What are entities? How are they created? What's really relevant? I'm going to focus on one of these areas tonight but I'm going to go over all four. First off entities are created 99.9% of the time under state statutes. If we set up a corporation, an LLC, or limited partnership we are paying a secretary of state. We are asking that state and their legislature to give us certain protections. I say it jokingly "but, what if you paid Tony Soprano to protect your business? And then somebody broke your window and Tony Soprano didn't do anything?" How often would you be paying Tony Soprano to protect your business? You'd quit paying him. You'd say I'm not getting anything out of it. You are paying the state for certain benefits. One of those benefits is limiting your personal liability. Those states have an incentive to give you that protection. Now you have a big boy on your side. You're paying them what amounts to on average about $150 a year. Depending on where you're at it could be nothing. In fact there are certain states where to have an LLC you don't pay anything on an annual basis but you get the protection. You may pay them 50 bucks and they say, "Hey you pay us a little bit of money. You follow our rules. Our state rules. And you're going to have this protection. You're going to have limited liability."

Then we also have to deal with the IRS. Our wonderful federal government. We have to say, "Hey, how do you want to look at us? How do you want to treat us?" These are two very different things. The federal law and the state law are two very distinct things. You can have the state say one thing and the feds say another. The state may say, "Hey you don't have to do anything with an LLC on an annual basis." But the feds may say, "Hey we want you to keep books up. And records." Something. How about private third parties? If you're dealing with a bank? They may say, "Hey we want you to look a particular way. We want you to do certain things with your entity for us to give you money." Well it's not covered under a state statute and it's certainly not required by the federal government. So why do I have to do it? They may say, "Well, because you want money from us." How about courts? Courts are another one. I clerked again for three different judges and the rule of thumb is the amount of respect you show your entity is the amount of respect they show your entity.

Yes, state statutes are important. Yes, IRS tax compliance is important. Yes, keeping a paper trail on your entity is important. At the end of the day if you just show it's separate and you follow that state statute, it's really tough depending on the court to undo these things. Now Nevada we have a very peculiar court. We don't have an appellate court. Basically the trial judges can get rid of things. We have a business court where we have one judge on the whole Southern half of the state. You're in there with all the big casinos. Do you think they want little cases? No they're going to toss them out. They don't care. They're not going to get appealed. They're not worried about it. We have very strong statutes that say “Hey, it's almost impossible to pierce. Unless there's fraud or criminal activity there's not an equitable piercing.” What does that mean? It means we have certainty. What you're paying for is the certainty. That's not everything we're talking about.

Tonight we really want to focus on one major thing and that is really coming down to our wonderful friends at the IRS. We're going to focus on the IRS and how they view the entity. Because believe it or not you could have it set up to where the state recognizes you. But the IRS ignores you. That's what we're going to be looking at. All right, according to the IRS, and this check the box regs came up 1996 1997... the check the box regs, which if you care about Internal Revenue Code 7701 came about really January 1st. They were enacted in 1996. Came into effect on 1997. It says that any business entity that's not required to be treated as a corporation. In other words if you set up a corporation, guess what? You're a corporation. But anything that's not, so if you are a LLC, if you are a partnership, if you are a limited partnership, then you may choose your classification. There are default classification rules. But eligible entities may elect out of the default rules. What does that mean? It means you have choices. Here’s the entity election process and you can absolutely grab these slides later if you want this slide because it's not the biggest slide in the whole world. I will send it to you and you can share it with your accountant or whoever is bugging you that's saying, "No, you can't have a disregarded entity." Yes you can. What it is is, hey, we follow the check the box regs. A business entity is any entity recognized for tax purposes and is not properly classified as a trust or otherwise subject to special treatment. Hey guess what? An LLC fits right within that category. Certain corporations could even fit within that category. Then we fall and say, "Hey okay a business entity that is not necessarily classified as a corporation." Oh cool. We don't have to have it as a corporation. Then there's some rules that say, "Hey, if you have two members you can either be a partnership or a corporation or if you're a single member..." This is the big one. This is where these guys miss it, "A disregarded entity. Separate from it's owner. Disregarded entity." The activities, and this is a quote from the IRS, "The activities of a disregarded entity are treated in the same manner as a sole proprietorship branch or division of the owners.

A lot of folks think about disregarded entities and they think of an individual. It's a person. A person or a member can also be another entity. You could have an entity that owns another entity. You could have that entity that it owns disregarded for tax purposes. In English, if you have one owner, it doesn't matter whether it's you or your entity you have choices, the owner can be a husband or wife in a community property state as well. It can be a trustee of a trust or another entity. The IRS says, "The activities of a disregarded entity are treated in the same manner as a sole proprietorship, branch or division of the owner.” In other words no extra tax return. If you are a husband and wife and you live in for example, the state of California. You do not have to file a federal tax return on that LLC. Period. I don't care what your accountant says. You don't have to. You may have to file with the state, to do the secretary of state and in a couple of states you may have a franchise tax form. Like California has one. Texas has one. They don't really have a fee that you have to pay in Texas. Most states don't but you may have a state thing. The federal government says put it on the owners tax return. We don't even want to see it. We're going to ignore it. In other words it doesn't exist as far as we're concerned.

Here's common mistakes and I see these every week. The accountant files a 1065 which is a partnership return on a disregarded LLC. Sometimes they'll even put 0% ownership. They still file it. Why do they file it? Because they can charge you for it. The accountant runs pay roll on a disregarded LLC owned by an individual. I see this all the time. They're going to subject you to penalties that cost you a lot of money. We'll see that even with sole proprietors. An individual owner of a single member LLC classified as a disregarded entity is not an employee of the LLC. Instead the owner is subject to tax and the net earnings from self employment of the LLC, which is treated in the same manner as a sole proprietorship. If you are a sole proprietor and you are running pay roll on yourself you are going to get hammered at some point for old age and disability and Medicare. Because the company is technically paying half you're not. They will penalize you on the amount that you didn't pay your second half. They will not give you credit for the half that the business paid. It's silly. It's weird. But that's the rules and that's how they treat it. They will penalize you and it's like a 25% penalty.

Your accountant files multiple 1065s instead of consolidating into a holding entity. I will show this example. When I say, "Hey here are some quizzes for your accountants." This is kind of fun. You can make them mad. You can make them turn red. We'll show you how you can eliminate a lot of the expense of filing a whole bunch of 1065s. I've seen people come in with 10 entities that are all paying. They're doing partnership returns instead of a single partnership return and having them all as disregarded entities. It really comes down to the accountant says, "This is how I do it." They're charging a 1000 bucks a pop and the next thing you know you go from a situation where you may not even have to have filed a separate tax form on these but they’re charging an extra 10 grand a year.

How about the accountant does not obtain an EIN for the LLC? They think they're so smart because technically they may not have to for federal tax purposes. But remember we're also dealing with courts, banks, and the state. We want to make sure that if we're putting an asset protection plan together that we don't give the other side something that they can walk through. There's no better alter ego argument than it doesn't even have it's own bank account. And you're going to need an EIN for a bank account. If you are co-mingling between the two nonstop buying groceries out of your entity, paying for kids tuition directly out of the LLC that has a rental don't expect it to hold up.

How about the accountant fails to make a QSUB election on an S Corp? A QSUB just means that if you have an S Corp and it owns another S Corp 100% that second S Corp does not have to file a 1120S. It can file it on the parents 1120S. A lot of accountants are completely unaware that you can do that and they end up filing and keeping an extra set of books. And they file an extra return. You don't have to do that. We're going to talk about this. Disregarded entities. What are the disregarded entities as far as the IRS is concerned? LLCs with one owner not electing corporate status. A husband and wife again in a community property, state may elect to be treated as single owner. Wholly owned S-subsidiary of an S-Corporation. This is a very specific example. If you have an S-Corporation and you have a subsidiary that's an S-Corp or if you wanted to have a subsidiary that's an S-Corp, it doesn't have to file it's own tax return. That's a pretty big one.

Let's get into the quiz. All right you can ask your accountant. How many tax returns do I have to file? We have three state. State A. State B. State C. Let's just pretend this is Nevada, Georgia, and Florida. And they each own a rental property or two or three or whatever you want to have. Just say how many tax returns do I have to file? If your accountant comes back and he's this guy and says, "Hey. you should have to file one, two, three returns." Give me a call. Because chances are their costing you a ton of money. How many tax returns do we have to do if we set it up this way? We have a single holding entity holding those three state entities. Now how many returns do we have? Wait a second. You mean I can get by with either one or none? If you're in a community property state this structure carries with it zero federal tax compliance. It is on your schedule C as though you owned it in your individual name. I am not kidding. Some of you guys are probably already getting mad. Because your accountant has been charging you for a whole bunch of partnership returns. We also have... so we're looking at this holding entity right here. Hopefully you can see my little cursor. I'm going to twirl it around real close. That holding entity if you're a husband and wife in a separate property state and you own this holding entity that owns the other three entities. You would have to file a single informational return called a 1065. But the three entities down below don't have to file anything.

Now let's go to another one. Let's go back. How many tax returns do we have to file if we have... let's say, your living trust is sitting there. We have 20 rentals in separate LLC's owned by a holding company. Let's see you have a residence. We have cars. We have a boat. We have a bank account. We have a commercial building in an LLC that you own. You’re husband and wife. We have a Nevada LLC holding a bunch of brokerage accounts and safe assets. We have a holding LLC holding 20 different rentals. We have 20 LLCs and we'll just put them in all different states. All over the place. How many tax returns do we have to file? Zero. Let's add a pension plan to it as well. Husband and wife... the pension plan is a tricky one. It's not a disregarded entity but it may not even have to file a tax return if you have less than $250,000 worth of assets inside of it. It's a husband and wife, no tax returns necessary. Does that make sense guys? I hope that you're seeing this.

How many tax returns were necessary on that previous slide. How many tax returns are necessary for this entire structure? Technically one. Yours. Your 1040. Everything there flows through. It gets better. Disregarded entity. Now you see it. It gives you liability protection. Now you don't. You don't have to file a tax return for federal tax purposes. Most states, like every state, follows that. With the exception of if you have a franchise tax. There's no state tax return due otherwise. Now you do. It's back again. Wait a second. For employment taxes. This is what we call mental gymnastics. This is the IRS giving us weird... I say weird that's a legal term. Very weird advice. Which means they said, "Hey for these LLCs..." which do not exist in the tax code by the way. There's no such thing as an LLC tax designation. You pick how you want it to be taxed. If you have employees then the question is whether or not the owner of that LLC is responsible for the employment taxes. The entity is responsible for the employment taxes. You could still be considered a responsible party just like you can on any business whether it be a corporation on down. But it is separate. This is another reason why you need an EIN.

Why do you need it? Because we want to make sure that we have liability protection. We don't want the co-mingling argument. We don't want the alter ego argument. For employment, we want to make sure we have an EIN. In fact you're required to have it if you have employees. An EIN is necessary to open up a bank account in the name of the LLC. You can't do it underneath your personal social. What that becomes is a DBA and I'm not going to get into DBA's here. It's just suffice to say that that would become a DBA of you. So it's still you. There's no liability protection. If you are using an LLC and your accountant said, "Hey we don't need an EIN." Go back and get that changed. You can actually do it on yourself. Fill out the SS4. Change of entity election. Actually you just do it as an SS4. You can do that online and get that. Or you can call us and of course email me and I'll be happy to help.

I see a bunch of questions coming up or a few questions and I'll get into those before we are done tonight. All right, let's go over a bunch of typical structures. I like to do these. Let's say that we have some rental real estate. We put the rental property into a land trust to avoid the due on sale clause and then we assign it to the LLC for tax protection. There it goes. We deed it in to the land trust. Then we stick an LLC around it. How many tax returns are due on that structure? None. Zero. Zilch. You still believe that's not a good idea? Again a lot of times if you're not up on it, you're down on it. Somebody doesn't understand how simple this is and there's not a lot of fees that go along with it, makes a huge difference. Huge difference. This now protects you from the liability that's going on inside here. I'm going to move my cursor around it. Inside this land trust and this LLC you could have a multi-million dollar verdict in it. They don't get to come take your wages or your other assets. It's very important. I don't care. There's no such thing as an insurance policy that can guarantee that.

Next thing. This is a fun one. Let's say that we're flipping properties in multiple states. You could actually set up a parent corporation in Nevada. Why would you do it in Nevada? A, it's anonymous. B, nobody can take your shares. It's the only state in the union there is no other. It is the only state in the United States that protects the shares of the corporation. They cannot take your shares. It gives you charging order protections. Nobody else does. Not Wyoming. Not Delaware. Nobody. If you have this you don't have to worry about somebody coming after you for anything and taking your shares away. They cannot foreclose on your shares. They cannot take them away. The most they get is a charging order meaning that if you have a C Corp, they're waiting for you to issue a dividend. Which means they can hold their breath and they will probably run out of oxygen long before you'd ever decide to issue a dividend. What you do is you have several states where you're doing flipping. Instead of registering that corporation in each state and possibly losing it's anonymity, you could have that corporation just own an LLC in each of those states. Does that make sense? It's disregarded so everything ends up on that single 1120.

So you could have again 20 LLCs in each state where you do flipping, where you're doing buying and selling properties. At the end of the day you have one set of books and one 1120 or 1120 as if it's an S Corp. Pretty cool? Absolutely. All right, how about this typical structure? I've done this on many occasions. When you have assets and you have a traditional business and maybe it has activities. For example, it's developing intellectual property or it has a division and you want to run it under a different name. You're thinking of spinning it off and selling that division. You could set it up as a disregarded LLC. It all shows up on your main tax return. You do that for banking reasons or for valuation reasons. Especially if we're doing publicly traded companies or companies that have investors and you don't want to have to go through and list out each division or give up... certain extent you don't want to give out trade secrets, then you could develop different lines underneath these LLCs. At the end of the day, now you could bring in somebody else to partner on that same LLC and it's already separate. It's already been separated out. It's keeping us from having to do a whole bunch of tax compliance in the meantime. It's an extremely effective tool.

Now here's the QSUB election. Let's say I have a parent S-Corporation. I'll give you a real life example because I actually lived this. Anderson Law Group is a PLLC. It's a professional limited liability company that has declared S status and it owns subsidiaries that are QSUBs. We made a QSUB election which means we're treating that as a qualified s-subsidiary. Meaning that we file one 1120S for the entire organization on an annual basis. We don't have to do multiple. Again lots of accountants like to do these each as their own S-Corp because they don't understand that it's even possible to own an S-Corp through another S-Corp. Just because they've just... I don't know... either they just because they've haven't been exposed to it. Chances are that's probably why. Because if they knew how easy it was they would absolutely do this. It's beneficial for their client because it's saving the client money and it's less tax compliance. Again sometimes the accountants that are devious like the extra returns, like to do lots of paperwork and they bill by the return.

All right, another one is a parent corporation. We already had the different brands and the different ones we already went through that. Here's a good one. Let's say that you have a pension plan. You roll your IRA, an exiting IRA, into that pension plan. You decide that you want to invest in some real estate or some risk business. You also have some stocks and bonds. Rather than subject the stocks and bonds and even yourself to the liability that comes along with that real estate, just open up a disregarded LLC. Have the pension set it up and viola you've now isolated the liability and you don't have any extra tax compliance. It doesn't have to file a return. Pretty cool again.

All right and then we'll go back to our beginning one. The holding LLC that has a bunch of states or a bunch of LLCs in other states that own real estate. Even if it's in the same state we don't care. We like the holding LLC, which could be, let's say that's a Nevada holding LLC for some of the same reasons anonymity, protection, and charging order protections. We want to make it so it's very difficult for anybody to get to your assets. If something happens and you have personal liabilities, this whole structure may not even require tax return. You could multiply that out. You could have 50 LLCs. 100 LLCs. No tax returns. Zero. Zilch. Fun stuff.

Here's your last little bit. Its' your cocktail party quiz. Is an S-Corporation a disregarded entity? Oh, that's a good one. Because the answer is it depends. An S-Corporation that files an 1120S is not considered a disregarded entity. It just passes on the profits and losses to it's shareholders. An S-Corporation that is made a QSUB election is. Kind of cool. If you bring that up at a cocktail party with a bunch of accountants and they're going to think you're really smart.

All right is a partnership a disregarded entity? The answer is no. It files an informational return on an annual basis. There's no situation which a partnership or something that has two or more owners that are not husband and wife in a community property state. But if you have two or more owners that are not married in a community property state, there's no situation where it is a disregarded entity. That partnership would file a 1065, an informational return and then it would give K-1's to its partners saying, "Hey, here's your portion of the profits and loss."

Is a sole proprietorship a disregarded entity? No, because a sole proprietorship is not an entity. It is you. You are a person. There's no legal distinction between you and your activities as a sole proprietor. Which means you do something goofy in your sole proprietorship, you can expect to be paying for it for the rest of your life unless you bankrupt it away.

Is a living trust a disregarded entity? Technically no. It's kind of you again. It's a grant to a trust. For this purposes, we're going to say “sure it's a disregarded entity.” Because a living trust doesn't file a tax return unless it chooses and once it becomes irrevocable. So again you can go out there and wow your friends at a cocktail party or never get invited back depending on what the crowd is like.

All right, anyone can do it. Anybody can put together a plan. You don't need to be an attorney or an account. Obviously the attorney and the accountant are helpful if you want to point the finger at somebody if you do something and it doesn't work because of a mistake made. If you do it yourself, you have no reprieve. If your accountant or your attorney does it quite often the courts will say, "Hey we can see your tax payer intent" and they won't punish you horribly for it. That's one of our attorney's there. No I'm just kidding. Anybody can set this up and operate it. It's not rocket science. If you have any questions and I will answer some of the questions here. You can get me at tmathis@andersonadvisors.com. You'll see that I will absolutely respond. Sometimes it takes me a little bit if I get inundated. You can also grab a time on my calendar so if you have very specific issues, you're a member of our platinum program, which is a great deal at 35 bucks a month, you can go ahead right under my calendar and grab a time and I will call you at that time or you can call me at that time, however, you choose and we can make sure we talk.

Now let's go and take a look at some of the questions. Number one we had, Ink University, we just had it this weekend. It was absolutely fantastic. I loved that. I taught the better part of two of the three days. Really enjoy meeting with other business owners. I tell this from the front of the room. I said, "You're going to learn more from the guy to your left and your right and who's behind you than you're going to learn from the guy at the front of the room." It's being around like minded individuals. Sometimes it's good just to be around someone who's doing what you're doing. A lot of folks for whatever reason don't feel comfortable coming up with a question they think is dumb. They'll say, "Hey, I'm not going to talk to the attorney. He's going to look at me and think I'm an idiot." They'll ask the person next to them and that's where you really get some learning. Also you guys can share your experiences. It's a great event. We go over it. It's just for business owners. We talk about how to best run your business and get the most out of it. We talk a lot about tax. We talk a lot about things like funding and getting business credit. Stuff like that. That's only relevant to those of you who actually have structures. It's a great time. We'll be having another one I think we're looking at February in Las Vegas but we will post it and we will let you know.

My CPA told me not to worry about setting up the LLCs since I'm going to be using a flow through entity [inaudible 00:59:30]. That's great Judy. Again I would just fire them. They're not thinking straight. If you have a liability producing asset then either have them sign on and indemnify you or put something in place to isolate the liability. It's my experience. I've been doing this for a long time. My experience is that you don't know when the liability occurrence is going to come. We can't predict it. It's really cheap. In most states you're talking about 100, 200 bucks to keep an LLC going. There's a little bit of upfront costs but compared to carrying more insurance which is what a lot of these guys recommend you will have a much greater return doing the LLC and you will stop the suit. The bigger issue is if you use an LLC in conjunction with a land trust, your name will no longer be on it. That's huge and if you have other assets, that's invaluable. What we want to do is make sure that you do not look like an attractive target in the public record. We want to make sure that they look at you and say, "Oh, this person doesn't have a lot for me to shake down." It's like when was the last time you saw a homeless guy get sued?

Slides, I will absolutely make them available to you. Shoot me an email. Let me know where to send them and I'll send you the Power Point Presentation or at least a PDF of it. I have a question regarding Trump Organization set up as an LLC. Is the Trump Organization LLC a holding company? Yes, it is a holding entity. You must have LLCs on other business assets in order to eliminate his liability? That is absolutely correct. See you're seeing it. The difference between the LLC that's making $10 million, $100 million, and $1 million or $1000 is zeros. It's the same rules. All this LLCs income [inaudible 01:01:13]. That is absolutely correct. You are now seeing it. Most of the publicly traded companies out there including Microsoft... if you just for kicks go to the state of Nevada and just want to go look at Microsoft holdings and all of their various entities you'll see that they keep their trade secrets very private. They don't want you to know who their partners are and development partners. They'll set up these joint ventures here because there's no disclosure. It all flows onto who's tax return? You got it. It's going up to Microsoft. Pretty cool.

Okay. My husband and I have a LLC and a corporation in Nevada. We live in California. We were working with your offices and have been set up for tax purposes as a partnership. Is there any reason we were set up this way as opposed to disregarded entity? Elizabeth, the only time that we were setting up LLCs as partnerships is if we wanted to make sure that we had activity that would flow onto a different section of the Schedule E. It depends on what that particular entity owns. Most of the time in California I like using a disregarded LLC because for franchise tax purposes if we own it as a trustee of a trust we can avoid paying the franchise tax on something that's out of state and that's according to their... what's it called? It's their professional hotline. It's their practitioners hotline. We went through one audit where that's the position they held. We can actually avoid the $800. It's one of those things that we don't publish a lot. Because frankly we think they'd probably stop that loophole if they really gave thoughts because they're hurting for money. They're looking for money everywhere.

Okay. Let's see, it would be great if you could send me that slide you put up about the IRS and kind of mistakes. Also would you repeat what you said about putting an IRA in a pension in an LLC. Quinn. All right so Quinn, you can set up a 401A plan and you can fund it either with contributions made from salary or you can roll an existing qualified plan like a past employer 401K or an IRA into it and have access to all that money. In other words a lot of times we have an IRA and my wife has an IRA and everybody has a different IRA. I have two or three. I have an old 401K and they're all invested in different things. We can consolidate it all. As a punch line we can actually borrow money against it. We can borrow up to $50,000 per participant. If it's a husband and wife you could get up to $100,000 at Federal AFR rates, which are hovering right around now about 4%. Pay off some other debts. Increase our personal credit, which will lower our interest rates that we pay on things like mortgages. Stuff like that. Allow us to qualify for better loans. There's a lot we can do. What I was saying there is if you did do that and then you weren't investing in an asset like real estate, don't co-mingle all your cash with a risk asset like real estate. Put it in an LLC to make sure that the liability doesn't come over and get you and doesn't take your other pension funds.

All right, next one. William. We are platinum members. My understanding is you charge per entity for taxes. Should we have signed up for that at our entity seminar and was there a discount then or do you have a standard fee for each entity? I thought I was told it was $300 per entity. What do we need to do prepare for our taxes so we're ready? Yeah, we have on our website in the client area, tax organizers. We can either quote you based off of the information you provide what it would cost to do a return or if it's a fairly basic structure you can call us at 800-706-4741 or go on our website and request a consult. We can quote you in what we do. We're probably about 75% of the average out there. Just because we do such a high volume and because this is our specialty. The treasury inspector general two years ago did a study of chain preparers and small tax preparers and found that in the chain preparers they gave them a scenario of a tax scenario where they were... we call it ghosting. Where they go in and they pretend to be a tax payer and they give them a scenario and they give the same scenario to a whole bunch of preparers to see how many of them get it right. In the case of chain preparers, they have a zero percent success rate on business returns. They got every single one wrong. Then they went to small preparers and they did the same test and the small preparers did better. They only screwed up 94% of the cases. We live in this area. Again it's not rocket science, but it's something that you kind of have to do. Otherwise you're just not going to get it. We end up being a lot cheaper than a lot of others just because we do thousands of corporate returns and individual returns and partnership returns. We're used to it. We've been doing it. We've been down here. Our companies go back to 1993 so a little over 20 years. We're pretty good at it and we pass that on to you guys. We'd be happy to give you a quote.

Let's see, so are all holding companies disregarded? Max. No. If a holding company is set up it could either be a partnership corporation or disregarded. A lot of times if we're setting it up just for asset protection or estate planning and we don't have a tax appetite. We're not trying to accomplish anything with another tax return. We'll set it up so there's no tax returns necessary. Because at the end of the day it's about making sure that the plan makes sense. When we weigh it and we say, "What are the costs of maintaining it?" We want to make sure that we don't have a lot of maintenance costs.

Ivan says, "What does a living trust file annually?" Nothing. Unless it is irrevocable. A living trust by it's definition is, it's alive with us. We are the grantor. We are the beneficiaries during our lifetimes. We don't have to file anything. If I die then it becomes irrevocable and it may file a 1041. That's only if I pass away. Even then I may just distribute it. Please provide the slides. Thanks for the presentation. Thanks Alan. We will absolutely do that. What I may do is have our tech guys figure out everybody's emails and send you guys out a link to the presentation. Let's see if there's any other questions. That may be it. No there's one other. Do traditional and/or Roth IRAs need LLC protection from creditors? Yes. Otherwise it flows down to the owner. If you have just nonrisk assets you don't have to worry about it but if a retirement plan does have real estate that's risk real estate, you should put it in an LLC inside the retirement plan.

Okay I've gone about 10 minutes over. Thank you guys for attending. If you have any other questions, hopefully you know now you can just email me. Or you can go on our site and you can request it. Share this with your friends. As always we're going to post this on our site so you can see the replay. Get the word out that there are alternatives than to just giving money to insurance companies or just sitting on your hands and subjecting yourselves to liability that you don’t need to. You can actually set up structures that don't have a lot of compliance and don't have a whole bunch of elbow grease necessary. Until next time, this is Toby Mathis. Thanks again.

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