

ESTATE PLANNING AND THE LIMITED LIABILITY COMPANY

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Limited Liability Companies are the most common form of business entity today. They can also be powerful tools for estate planning. This memorandum will help you to understand how they operate and the many benefits they offer. Briefly, a Limited Liability Company, in this context, is among family members and allows joint ownership of family-owned assets. The structure of the company permits a member to transfer a portion of his ownership of the assets held within the company to other family members who are members to the agreement. The use of the LLC to make such lifetime gifts, as well as transfers at death, lays the groundwork to obtain a potential discount (valuing a company interest at something less than face value) on the value of the transfers. In addition, holding family assets in a LLC provides a measure of protection from creditors of the company and of individual members. A LLC provides several other advantages, which this memo discusses in greater detail. After you have reviewed this memorandum, please call us with any questions that you may have.

What is a Limited Liability Company (LLC)?

A Limited Liability Company ("LLC") in the context of estate planning for a family, is a company owned among family members that is created to allow joint ownership of family-owned assets. The existence of the company is evidenced by a written agreement that details the terms of the company and the rights, duties and obligations of each member.

The member's liability is limited. This means that the members in the company are only responsible for company liabilities to the extent of the value of their company interest. By comparison, in an unincorporated

business, the owners have liability for all of the activities of the company and that liability is not restricted to the value of the company interest of each owner.

What are the benefits of establishing a LLC?

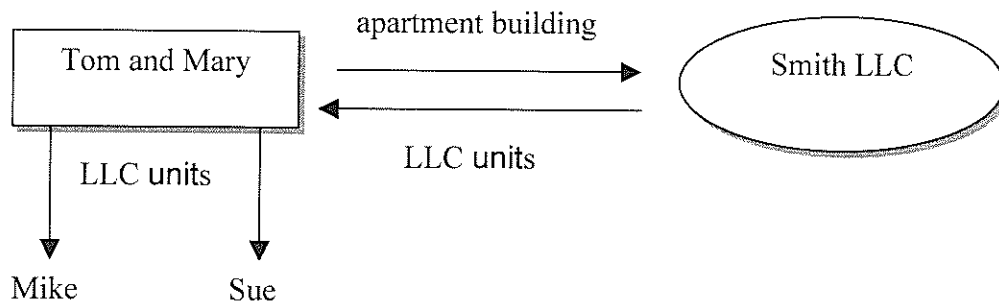
There are many benefits to implementing a LLC as part of an estate plan. The two primary benefits are 1) to "fractionalize" interests in property for the purpose of carrying out a gifting strategy and 2) to seek "discounts" on gifts made and on the transfer of a member's remaining interest in the LLC at death. These benefits of a LLC also reduce death taxes.

How does a LLC "fractionalize" property interests?

When property is transferred into a LLC, company units or interests are created and assigned a value. The units represent a fractional interest in all of the company assets, the same as stock in a corporation. This makes it possible and convenient to gift assets which are not easily divisible. The LLC creates a "currency" of company units that can be easily transferred on an annual basis.

Fractionalization of property interests can best be explained by an example:

Tom and Mary Smith want to give their children, Mike and Sue, a portion of an apartment building that they own. The reason for the gifts is to reduce estate taxes at death. Tom and Mary create a LLC with themselves and Mike and Sue as members. Tom and Mary transfer the building into the LLC by quit-claim deed. The fair market value of the apartment building is professionally appraised to be \$500,000. The members agree that the LLC will have 500 units and that each unit is worth \$1,000. Tom and Mary can now give units of the LLC to each of their children. Without a LLC, the only way to make gifts of partial interests in the real property would be to execute deeds to the children each year, which would be a cumbersome, confusing process.



What are "discounts" of LLC interests?

Briefly, we take the position, where justified, that minority interests in a LLC should be valued at something less than face value because the owner of a minority interest cannot realize the full value of his company units if he were to sell them. In our example, assume Tom gifted 10 of the 500 units of the LLC to his son, Mike. Mike's ownership of 1/50 of the LLC should be subject to a substantial discount for several reasons including:

- a. A discount for lack of marketability. Who would pay full value for an interest in a company owned and controlled by a family?
- b. A discount for lack of free transferability. The terms of the LLC restrict the ability of members to sell or otherwise dispose of their interests.
- c. A discount of the interests of the limited members because management control is in the hands of the managing member.
- d. A minority interest discount. A minority interest is less valuable than a controlling interest.

The terms of the LLC agreement are carefully designed to maximize the ability to take a discount. Potentially, a discount can be taken both at the time ownership units are gifted from one member to another and at the death of a member on his remaining ownership units. A successfully taken discount can result in a large estate tax savings.

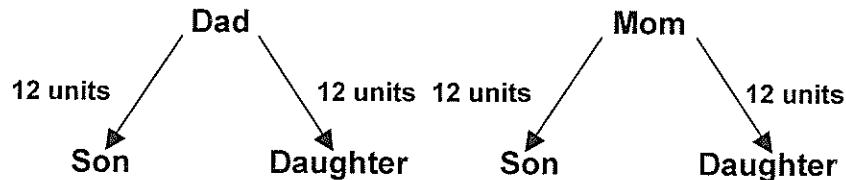
Why is the valuation discount so important?

Discounts can potentially be taken at the time a gift of a company interest is made from one member to another and also upon the death of a member on his or her remaining operating interest. Many factors, including the terms of the written operating agreement itself as well as the

type of assets owned by the LLC, contribute to the determination of the appropriate discount to be applied. It is very common to see a discount between 30-40% and higher discounts have been successfully applied to interests in LLC interests.

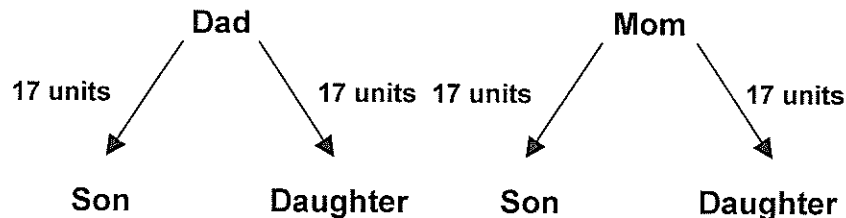
a. Using the discount with annual gifts of units. Under current tax law, the annual exclusion to gift taxes permits a donor to give up to \$12,000 per year to as many donees as he chooses. Thus, if each company unit is valued at \$1,000, a member could gift 12 units to each other member and have each gift qualify for the exclusion. However, if a 33% discount is taken on the value, the donor member could gift 17 units to each other member and still have each gift qualify for the annual exclusion. This helps to reduce the value of the donor's taxable estate more rapidly, thereby reducing the amount of estate taxes that may be owed upon his death. The impact of the discount applied to annual exclusion gifts can be significant if annual gifts are made for several years. However, to qualify such gifts of LLC units for the annual exclusion, the LLC agreement must be carefully drafted. The agreement cannot unfairly restrict a member's ability to sell or assign his company interests or allow a member to act against the best interests of the other members, such as withholding income distributions without a valid business purpose.

Without a discount:



Total units gifted: 48

With a 33% discount:



Total units gifted: 68

b. Using the discount at a member's death. A LLC can produce a large estate tax savings in that a discount potentially can be taken

on an ownership interest owned by a member at his death. For example, if a member owns 750 units each valued at \$1,000 at his death, the deceased member's estate would include \$750,000 of units with no discount. If a 33% discount were successfully taken, the estate would only include \$495,000 of units, which will reduce estate taxes by approximately \$127,500 for an estate being taxed in the 50% tax brackets (federal and state combined).

The specific circumstances surrounding each LLC must be evaluated when deciding how much of a discount can reasonably be taken. The IRS may challenge the amount of a discount so tax savings are not guaranteed.

What are the rights of a limited member?

The LLC agreement sets forth the basic rights of the members. They are to be consulted with regard to all major decisions and have a right to inspect and examine the books and records of the company. However, they do not have the right to make decisions on behalf of the LLC or to control the general member.

What types of property can be contributed to a LLC?

Almost all types of property can be contributed. Most frequently, we will recommend that real property interests such as commercial property or vacant land be used to fund a LLC. A LLC can hold investments such as stocks, bonds and mutual funds, as well.

S corporation stock; however, cannot be transferred to a LLC because of legal restrictions on the ownership of this type of stock. Also, it is not advisable to transfer units of stock in a family owned business that is a C corporation. The retention of voting rights of that stock by a member can cause inclusion of the stock held in the LLC in the estate of the member at his or her death. Further, qualified plans cannot be transferred into a LLC.

Can a LLC own life insurance?

A LLC can own life insurance; however, the agreement should be drafted very carefully to avoid inclusion of the proceeds of a policy in the estate of a deceased member. This is a very real possibility when the insurance is on the life of the member. The Internal Revenue Service could take the position that a member's powers create "incidents of ownership" over the policy that cause inclusion of the proceeds in the general member's estate at death. This problem can most likely be avoided by careful drafting of the operating agreement to include specific language prohibiting a

member from exercising any powers or ownership rights over life insurance on his life that is owned by the LLC.

Even if the "incidents of ownership" issue is resolved, there will still be included in the estate of the deceased member an amount of the proceeds equal to his percentage interest in the company.

Currently, we usually do not recommend that life insurance be placed in a LLC. We still find the use of an irrevocable life insurance trust to be preferable for a number of reasons, including our greater confidence that all insurance proceeds will be kept out of your estate for estate tax purposes.

How is property transferred to a LLC?

If real property is being transferred, a quit-claim deed transferring title to the LLC must be prepared and recorded. If investments are being transferred to a LLC, they should be put in the name of the LLC using its tax identification number. Any non-titled property can be assigned to a LLC by a simple assignment.

Is a gift made when property is transferred to a LLC?

No, because a transfer of property to a LLC is treated as a contribution of capital to the contributing member's capital account. A gift does not occur until a member transfers a portion of his or her units in the LLC to other members.

Is the transfer of property to a LLC a taxable event?

No. The transfer of property to the LLC is not a sale and the transferor does not realize any capital gains or losses. The basis in the property (i.e. what was paid for it plus the cost of capital improvements less any depreciation) remains the same and there are no tax consequences that arise because of the transfer. However, when one member transfers units to another, the member receiving the gift takes the transferring member's basis in the property.

Should the property contributed to a LLC that does not have a readily ascertainable value be valued by a qualified appraiser?

We believe that property such as this should be appraised. If gifts of this property are going to be made and if we are unsure of the underlying value of this property transferred to the LLC, we cannot be sure of the value of each unit. For example, if real property is going to be transferred,

then it should be appraised by someone competent to appraise real property.

Sometimes, clients do not want to go through the expense of an appraisal. In this circumstance, the members will agree on the value of property so contributed. However, we cannot be responsible for any problems or missed opportunities that may result. For example, if property is overvalued for gifting purposes, then smaller gifts than intended may be made during lifetime and this may result in larger taxes at death. Conversely, undervaluation of property could result in larger gifts being made than believed. This could result in gift taxes during lifetime.

The client's decision regarding this will be final but you need to be aware of these potential consequences.

Should a valuation be undertaken if a discount is being taken on the value of the LLC units being gifted?

A professional valuation should be done if we are taking a discount on gifts being made so that the amount of the discount can be defended if ever challenged by the IRS. The valuation would determine the amount of the discount. The determination of the amount of the discount is usually expressed as a percentage discount from the value of a LLC unit.

How are Units of a LLC gifted to other members?

Ease of transferability is one of the attractions of the LLC. The member desiring to make a gift of units of the LLC executes a simple one page assignment indicating the number of units he or she desires to gift and to whom the units are gifted. A unit ledger of the LLC is maintained and updated to reflect the transfer of ownership. The gift of units, however, must be to a person who is allowed to be a recipient of LLC units (another member to the company).

What are the benefits of limited liability?

If a LLC is sued because of its activities, a members' liability is limited to the value of their LLC interests and no more. They are not personally liable and their other assets are protected from the claims of a company creditor.

Protection from creditors is built into the terms of a LLC agreement. If there are any special circumstances involving a real or potential creditor, please bring this to our attention so that we may determine if anything else should be done beyond our standard approach to creditor protection planning.

How does a LLC protect the members from a member's personal creditors?

The terms of the agreement prohibit the transfer of LLC units to a creditor of any of the members. The creditor's only remedy is to require the LLC to distribute to them any company distributions that a member would otherwise receive. If any such distribution is made, the creditor becomes responsible for the taxes owed on the distribution, making most creditors reluctant to pursue a company interest as a form of payment.

If a member becomes aware of any real or potential problems concerning a creditor of any of the members, we should be notified promptly so that we may advise if anything further should be done to protect the LLC or its members.

Who is entitled to receive the profits and share in the losses of a LLC?

Income of the company is taxed to each of the members in accordance with each member's percentage ownership of units of the LLC. Income is the gross income less its expenses. Losses are shared in the same manner as profit.

For estate planning purposes, it is advisable to shift income to the other members. These are family members and the income shifted to them is frequently taxed at a lower rate. Additionally, transferred income will not be taxed in the transferring member's estate at death. Shifting income is like making additional gift tax-free transfers to your family members

Does a LLC have to distribute all of its income to the members?

Any company, including a LLC, may retain income for future needs of the company. It is not required to distribute all available income to the members. The agreement gives the members the right to determine if income should be retained in the company.

This is important to remember. A business plan for a LLC can still be followed and all of the income earned is not required to be distributed each year to the members.

Income retained is still taxed to the members in the same manner as stated above and they also retain their rights to a distributive share of this income if later distributed.

Does a LLC have to file a tax return?

This is dependent on the activity that takes place in the company during the course of a calendar year. If necessary, it will be filing a partnership tax return using its own tax identification number. Each member receives a form K-1 which states the portion of company income attributable to him or her and this form is attached to the member's own personal tax returns.

Preparation of the return is not difficult as it uses the same information as is used on the members' personal returns. Preparation of the members' personal returns is simplified because the same information is provided on the LLC's return instead.

Does a LLC need to have insurance for potential liabilities?

Keep in mind that the LLC is a business enterprise and should carry insurance for potential liabilities. In that there is a lot of variety in the types of property owned by LLCs, it is difficult to generalize as to the insurance that is appropriate. Your insurance advisor should be consulted at the time of the creation of the LLC as to the appropriate coverage and coverage amounts.

What happens if a member wants to sell his interest or withdraw from the LLC?

The terms of the LLC agreement dictate what is to happen in the event of a sale of LLC units. Any offer by a third party to buy a member's units is subject to a right of first refusal by the other members. The specific terms and conditions of a sale are set forth in the operating agreement.

Restrictions on the sale and transfer of units are an important part of the operating agreement. They not only insure that the only members are those persons whom are mutually agreeable to all members, but also sets up the conditions that allow for the tax planning and benefits that are an important aspect of having a LLC.

If a member wishes to withdraw from the LLC, the written agreement will specify how that is to be done and how the determination is made as to the value of the withdrawing member's interest.

Is the existence of a LLC recorded anywhere?

A certificate of a limited liability company is filed with the Secretary of State's office for that state in which the LLC is being created. We prepare the certificate and then file it after it is executed.

Do LLC units have to go through probate if a member dies or becomes incapacitated?

No. The provisions of a LLC can state that LLC interests are allocated to a trust of the deceased or incapacitated member. This is to insure the orderly transfer of all assets at death and to maximize tax planning opportunities.

If not otherwise provided for though, LLC interests are part of the estate of a deceased member and pass through probate. Members of the LLC whom we have not prepared an estate plan for may want to have this issue addressed. One of the advantages of having a LLC is that it can be used to avoid probate if the operating agreement provides how units are to otherwise pass at death.

How are a member's interests in a LLC coordinated with his or her overall estate plan?

As stated above, the operating agreement can provide that units of a deceased member pass to his or her revocable trust. This avoids probate. The units are then allocated in accordance with the terms of the deceased member's trust to maximize his or her personal and tax planning goals.

Do you have any other questions?

Please feel free to give us a call!

Smith and Condenti LLP