BUSINESS AND NONTAX REASONS FOR FORMING A LIMITED LIABILITY COMPANY (LLC)

A lot has been written about the gift and estate tax advantages of forming a Limited Liability Company (LLC). The purpose of the Tax Alert is to discuss some of the significant business and nontax reasons for contributing assets to a LLC.

Background.

LLCs, like limited partnerships, are usually formed as a part of an overall estate and business plan. The majority of all investment oriented ventures organized since 1985 have been in the from of limited partnerships or limited liability companies. Properly structured, a LLC is designed to continue the family resource base intact and undiminished, under family control, for future generations. Typically the LLC continues for a fixed term of years, and we recommend that the term be for 30 to 50 years.

Investment Standard.

The trustees of trusts are subject to the "prudent investor" standard which may retain successor trustees in their options for investments. A managing member of an LLC operates under the less onerous "business judgment" standard, similar to the practices which contributed to his or her wealth accumulation.

Centralized Management.

Many families find it helpful to have centralized management of the family assets. The older generation can exercise control of the partnership by designating themselves as the Managing members of the LLC. Often we recommend that the partnership interests be retained in revocable trusts, so actually the trustees of the trust are the managing members to avoid probate.

The managing members would have broad management powers to operate the LLC during the stated term. A "guaranteed payment" is frequently used to compensate the managing members for their services.

Succession Planning.

One of the foremost business reasons for a LLC is to meet the requirements of business succession planning. A LLC allows a family to maintain better control and management of income producing assets and begin to transition decision-making responsibilities from the older generation to other family members. Older members can then retire from those burdensome activities.

A LLC can also permit one or more of the children to step in and continue to operate the company in the event of disability or retirement for personal reasons.

Management succession can pass to family members best qualified to manage and preserve the family's unified resource base. Often this has already been put in place through the designation of successor trustees for the revocable trusts.

Assets Used to Fund.

Certain tangible personal property should not be transferred to a LLC. Normally items of a household or personal nature are not placed in a LLC. Also we recommend that the personal residence and retirement plan and insurance policies be left out of the LLC (they are usually better suited for a revocable trust or irrevocable life insurance trust, respectively). A LLC is not, under current law, an eligible S corporation stockholder. [Revocable trusts may retain S corporation stock for 60 days, or for up to two years if the entire trust corpus is included in the gross estate of the grantor.]
Cash, securities, bonds, partnership interests, real estate (other than a personal residence) and other similar investments may be appropriate for contribution to a LLC. Transfers of marketable securities may be subject to the 'investment company' rules. If marketable securities constitute at least 80% of the total fair market value of all the assets transferred these rules could come into operation. These rules are designed to negate investors' ability to diversify portfolios in a form of 'like-kind' exchange by contributing securities to a LLC. Where the initial members are husband and wife, the rules can be sidestepped by making interspousal gifts (which are sheltered by the unlimited marital deduction) to eliminate diversification before the contributions to the LLC are make. If the initial members are not husband and wife, the second member's interest should be less than 1% if more than 80% of the assets are marketable securities.

Asset Protection.

A LLC will also reduce a family's exposure to the legal system and the government, incident to claims and litigation. For example, over-reaching government officials might assert a claim for 'environmental clean-up' expenses without regard to fault. Tort litigation has become a $35 billion dollar 'industry' in the United States and the costs of defending against even groundless suits can be astronomical.

The Uniform Limited Partnership Act, which North Carolina has adopted, limits the rights of a judgment creditor of a LLC to a charging order against the income interest of the members of the LLC. A judgment creditor may not 'take' or 'own' or 'vote' the interest of a member. The charging order has proved to be an undesirable remedy for a judgment creditor. If the LLC does not distribute its income, the IRS rules state that the judgment creditor must nonetheless pay an income tax on its share of the LLC's income and gain (a 'KO by K-1').

The best 'asset protection' given to LLC membership interests has also proven to be a significant deterrent to economically motivated litigation in a divorce proceeding. Little may be gained by an 'ex' of one of the children, if all that plaintiff receives is a non-controlling ownership interest (which is difficult to convert to cash) or an assignee interest to income rights.

LIST OF 10 ADVANTAGES AND DISADVANTAGES OF A LLC

Pros

1. Centralized control/efficiencies
2. Asset protection from creditors/ex's
3. 'Business Judgment" standard
4. Promotes family harmony
5. Facilitates management succession
6. Minimizes imprudent spending
7. Spreads income tax burden
8. Flow-through taxation
9. Substantial Gift/Estate Discounts
10. Can be amended

Cons

1. Professional fees
2. Increases risk of IRS audit/challenge
3. Annual Secretary of State reports/fees
4. Lack of liquidity for heirs/donees
5. Donees take low tax basis
6. Doesn't negate need for revocable trust
7. Marketable Security pitfall
8. Congress may legislate changes
9. Fixed term of 30 to 50 years
10. Requires carefully drafted agreement

Most LLC agreements restrict the ownership of units to immediate family members. The transfer of a LLC interest to anyone other that an immediate family member, without prior written consent, could trigger a 'buy-out' at fair market value for the LLC interest (which because of marketability and minority discounts, would be less that the value of the pro-rata share of LLC assets). An attempted gift to someone other than members of the family could trigger the buy-out provisions; if a family member wants to sell an interest in the LLC, the agreement can give the LLC and the members a 'right of first refusal.'

Confidentiality.

Also, if a LLC owns and manages business and investment assets, the assets of the LLC are not subject to a statutory court-supervised guardianship or probate proceeding. The business and investment assets continue under management, without interruption, even though an owner may become disabled or die. Combined with a revocable living trust, there may not be anything subject to guardianship or probate.

The LLC agreement can provide provisions to facilitate resolution of family disputes through confidential mediation or arbitration, without the publicity associated with a lawsuit.

The limitations imposed by the Uniform Act also makes the LLC an ideal tool to protect ownership rights from contests and to deter litigation with regard to inheritance rights.

Family Unity.

Unification of the family business and investment economic base also promotes family unity. The family is motivated to stay together and work together because of a shared economic interest. A continuing business organization, such as a LLC, also tends to promote a 'community presence' which enhances the reputation of the family as a whole. It has been our experience that many families in business together and economically 'enabled' by the business, are prominent in charitable and community activities as they accept personal responsibility for others.

The creation of a LLC usually promotes knowledge of any communication about family assets. An annual meeting to discuss current operations, often held in a resort area away from day-to-day distractions, can be useful in fostering this communication.

By making younger family members members, the partnership can serve to introduce them to family business and investment decision-making.

The LLC units also provide a convenient and practical method of making annual exclusion gifts. On the other hand, fractional gifts of real estate and other assets can create family discord and partition suits.

Promotes Fiscal Responsibility.

Traditional planning often delivers a "spendable" inheritance to those who may be poorly prepared to manage and conserve investment and business resources until later in life. Sometimes it is necessary to limit the damage that income might produce, particularly income not of a child's own making. Through planning with LLCs, what will pass immediately to the next generation, and the next, is something they cannot cash-in and spend. Children are thus encouraged to make gifts to their children (the general partners' grandchildren). Unlike a traditional gift program that results in exposure to loss in a divorce proceeding or as the result of a child's financial misfortune, a unit of ownership in a LLC provides excellent protection from those claims.

The LLC interests can be denominated in units of relatively modest value, which are more easily transferred as annual exclusion gift that are undivided interests in real estate or other difficult to divide assets.

Income Distributions.

Generally, the LLC agreement should not provide for mandatory distributions of income during the LLC term; distributions should be in the discretion of the managing members. It is expected that they would exercise that discretion by making distributions to members in an amount at least sufficient to pay the federal and state income taxes.

Although a secondary benefit, a properly formed LLC can split income and move income, usually to a family member in a lower income tax bracket, to a child to help with his or her education, a business opportunity, or the purchase of a new home.

Other Disadvantages.

Among the additional disadvantages, are the following: (1) initial set-up costs and expenses associated with 'funding' the LLC, including a qualified appraisal, (2) the administration of the LLC including professional fees for filing annual income tax returns, and (3) the annual filing fee for reports filed with the North Carolina Secretary of State (the fee schedule is similar to that of corporations).