

Insights and Ideas
Family Limited Partnerships and Limited Liability Companies.

The use of family limited partnerships and limited liability companies can be a powerful family planning technique. In this Insight and Idea, we describe how a family limited partnership or limited liability company can be used to save gift and estate taxes.

TO: Client
FROM: Hartzog Conger Cason & Neville
DATE: January 1, 2007
RE: Family Limited Partnerships and Limited Liability Companies

A family limited partnership or limited liability company when used in the proper situation, can be a powerful family and estate planning technique. We use both family limited partnerships and family limited liability companies quite often in our practice. This insight and idea will generally explain how and why a family limited liability company (which we refer to as an "FLLC") works, why it works, and what its relative advantages and disadvantages are.

This insight and idea focuses strictly on the estate and gift tax savings potential of an FLLC. There are numerous other non-tax advantages and benefits to an FLLC. Further, as we will point out later, an FLLC will probably not achieve desired estate and gift tax benefits unless it also is formed for significant non-tax purposes.

Estate and Gift Tax Valuation Rules.

The law provides that if a donor makes a gift of property to a donee, the value of that gift for gift tax purposes is based upon what a willing buyer would pay a willing seller for the gifted property, neither being under any compulsion to buy or sell. Likewise, the law provides that if a decedent dies having property in the decedent's gross estate, then the estate tax value of that property is based upon what a willing buyer would pay a willing seller for that property at the date of the decedent's death. In determining the value of such transferred property, one must consider the factors which a willing buyer would take into account in making an investment decision to purchase that property. One factor is whether there would be a ready market for that property if the willing buyer desires to resell the property. Also, if the property is an interest in an entity such as an LLC, an important valuation consideration is whether the buyer of that interest will be in control of the LLC or whether that buyer's interest will be subject to the control of others. If an interest in an LLC is not readily marketable and is subject to the control of others, then it may be subject to both a marketability discount and a minority interest discount from its proportionate interest in the net asset value of the LLC's assets. Simply stated, a willing buyer will pay less for an interest in an LLC which is not marketable and which is a noncontrolling interest.

What Is a Limited Liability Company?

Oklahoma, as well as most other states, has enacted a special statute which authorizes the creation of a limited liability company (sometimes referred to as an "LLC"). The term "family limited liability company" merely refers to an LLC which is generally owned by the members of one family. However, there is no special statutory definition of a family limited liability company.

To form an LLC, articles of organization are filed with the Oklahoma Secretary of State. The persons who own interests in the LLC are referred to as its "members." A member is like a shareholder of a corporation. An LLC can have an unlimited number of members, or it may have only one member. Also, there can be different classes of membership interests, just as there can be different classes of stock in a corporation or different classes of partnership interests in a limited partnership.

The persons who are designated to manage the LLC are referred to as the "managers." The managers can be given as much power and authority as the members choose to give them.

The governing document of an LLC is referred to as the "operating agreement." The operating agreement is similar to a partnership agreement for a partnership. The operating agreement usually sets forth rules about how the LLC is governed, how interests in the LLC can be transferred, how the members will share in profits and losses, and so on.

An important attribute of an LLC is that the members of the LLC do not have personal liability for any LLC debts or other liabilities. Thus, the members of an LLC are shielded from liability in much the same way that shareholders of a corporation are shielded from liability. However, for income tax purposes, an LLC can be treated as a partnership. This means that the profits and losses of the LLC would not be taxed at the LLC level, but would instead flow through and be taxable to the members in the manner described in the operating agreement.

Example of How An FLLC Might Work.

Example: Let's suppose that John and Mary are husband and wife, have one child, and have a substantial joint estate. Mary and John want to reduce their potential estate tax liability but also retain control over their estate. John forms Smith Family LLC. The LLC Operating Agreement authorizes the issuance of Voting Units and Nonvoting Units. Voting Units and Nonvoting Units are identical, except that Voting Units are allowed one vote per Unit, while Nonvoting Units have no voting rights.

Next, Mary and John each contributes property worth \$2,000,000 to the capital of the LLC in exchange for 20 Voting Units and 1,999,980 Nonvoting Units. Meanwhile, the children provide property worth \$1,000,000 to the capital of the LLC in exchange for 10 Voting Units and 999,990 Nonvoting Units.

After the LLC is formed, the ownership would look like this:

<u>Member</u>	<u>Voting Units</u>	<u>Nonvoting Units</u>	<u>Total Units</u>	<u>Percentage Ownership</u>
John and Mary	20	1,999,980	2,000,000	66.66%
Child	10	999,990	1,000,000	33.33%
Totals	30	2,999,970	3,000,000	100%

Under the Operating Agreement, John is named the Manager and has the power to manage the business of the LLC. Under LLC tax law, all LLC net income or loss is taxed to the members in accordance with their Percentage Interests. The Manager will decide when distributions will be made to Members and how much will be distributed.

The Operating Agreement provides that the LLC will last for a fifty-year term unless all of the Members agree to terminate the LLC sooner. The Operating Agreement will contain severe restrictions on the right of a Member to transfer his or her interest in the LLC to any person other than a Smith family member or a trust having only family members as beneficiaries.

After the LLC is formed, John gives 5,000 Nonvoting Units to Child. For gift tax purposes, what is the value of John's gift?

In the alternative, suppose that John dies. What is the value for estate tax purposes of John's Units in the LLC?

At first blush, it would appear that the gift tax value of the 5,000 Nonvoting Units which John gave away would be \$5,000 (\$1.00 per Unit) or stated in another way, (0.001 times \$5,000,000 of LLC net assets equals \$5,000). However, keep in mind that the transferred property in this situation is a Unit of membership interest in the LLC. The transferred property does not include any of the underlying assets owned by the LLC. The issue then is what would a willing buyer pay for a 0.1% membership interest in the LLC? Because that 0.1% membership interest is not freely transferable, and because the owner of the 0.1% membership interest would be in a minority position and is nonvoting, a willing buyer would pay less for that 0.1% membership interest than its \$5,000 underlying net asset value. Thus, the transferred Units should be subject to both a marketability discount and a minority interest discount from net asset value. Let's suppose that the family determines, either through an appraisal or by other means, that the aggregate discount for the transferred 0.1% interest is 30%. Thus, the gift tax value of John's gift to the children is only \$2,500 and not \$5,000, as follows:

Net asset value of LLC	\$5,000,000
Interest given away	.001
Underlying net asset value	\$ 5,000
Less 35% discount	(1,500)
Value of gift	\$ 3,500

Look what has happened. By forming the LLC and making the 1% gift, John has in effect removed \$1,500 from his gross estate with no transfer tax cost. If John will potentially be in a 40% estate tax bracket at his death, then this transfer will have saved his family \$600 of potential estate taxes.

By the same token, when John dies, the Units owned by John at his death should also be eligible for an estate tax discount, computed much in the same manner as the discount for gift taxes.

The total estate tax savings to John and Mary, assuming a 35% discount on the value of their membership interest, applied either on gifts of those interests during lifetime or at death, would be as follows:

Net asset value of Partnership	\$1,000,000
Times discount percentage	35%
Valuation discount	\$ 350,000
Times gift/estate tax rate	45%
Estate tax savings	\$ 157,500

Determination of the Amount of the Discount.

In the example above, a combined 30% minority interest and marketability discount was used. The amount of the applicable discount in each case will depend upon the facts and circumstances of that case. Over the years, the courts have upheld discounts of anywhere from 10% to over 50%. Thus, John may want to seek an appraisal of the amount of the appropriate discount prior to making any transfers of an interest in the LLC. We are regularly involved in these matters and can help with an appraisal.

What is the penalty if the transferred property is ultimately determined to be undervalued for gift or estate tax purposes? Under Section 6662 of the Internal Revenue Code, a "valuation understatement" penalty will be imposed if the value reported by the taxpayer for gift and estate tax purposes is less than 50% of the amount ultimately determined to be the correct valuation. For example, if John makes a gift of an interest in the LLC and values that interest at \$10,000, but a court ultimately concludes (or the taxpayer ultimately agrees with the Government that) the interest was really worth \$20,000 or more, then there would be a valuation understatement penalty. The amount of this penalty is an additional 20% of the tax which was required to be paid but which was not paid resulting from the underpayment.

Current Status of the Law Applicable to Family Limited Liability Companies.

Over the past couple of years, the IRS has publicly expressed its dislike of the use of family LLCs and family limited partnerships. Most notably, the IRS has announced that it will seek to deny valuation discounts for family partnerships and limited liability companies which do not engage in an actual trade or business. Most suspect are entities which merely own passive assets and marketable securities. Nonetheless, as of this point in time, the IRS has only been successful in challenging FLLCs and family limited partnerships which have been structured and/or operated without close adherence to proper planning procedures and guidelines. Thus, it is critical that any family who wants to create and FLLC or family limited partnership to achieve estate and gift tax advantages should obtain professional advice from estate planning experts who are well versed in this area of the law, and those families should also be prepared to observe all of the formalities and do all of the extra things required to make sure that their planning is successful. Of course, there can be no assurance that the IRS will not meet with success in the future in reducing, or even eliminating, the valuation discounts which are presently available. However, if planned property, we believe that a family limited partnership or LLC can be a good estate planning technique.

Nontransfer Tax Reasons to Form a Family LLC.

Here are some nontransfer tax reasons why a family may want to create a family LLC:

A family LLC can reduce probate and estate administration upon the death of family members. If family business and investment assets are held in an LLC, then when a family member dies, that deceased family member's interest in the LLC will be transferred to other family members, while the business and investment assets will stay intact in the LLC.

Gift-giving can be simplified. Gifts of interests in an FLLC may be made merely through execution of a short one-paragraph assignment. This is simpler than having to make gifts through the physical assignments of real estate, securities, etc.

The family LLC can protect family assets from future creditors of a family member and from failed marriages.

The family LLC can be a useful vehicle to protect and preserve family wealth in one entity and prevent it from being proliferated among different family members where its value will not be maximized. The LLC will permit the centralization of management of family business and investment assets. The LLC may also prevent the transfer of family assets to persons outside the family. It can also be used as a means to encourage family members to look for and participate in new business activities and investments.

An LLC as well as a limited partnership is an extremely flexible entity. It can usually be created and dissolved with little or no income tax consequences. Thus, if the family ever determines to liquidate the family LLC and distribute out its assets, this can probably be done income tax-free to all of the members.