

The Family Limited Liability Company

This memo will describe the background and use of the Family Limited Liability Company.

Introduction

A family limited liability company can either be a partnership or limited liability company. Both are very similar statutory limited liability entities created under state law. For purposes of this memo both will be referred to as FLLCs. They are so named because ownership of partnership or limited liability company interests typically are limited to members of the same family unit. Because of the many tax and non-tax benefits provided by a FLLC it is frequently used as the foundation for a well organized estate plan. With proper planning, a FLLC ensures the orderly distribution of assets to subsequent generations at values that are reduced for estate and gift tax purposes.

Purposes And Uses

FLLCs serve a number of legitimate business purposes: for providing continuous ownership of property within the family unit; consolidating ownership; providing a deterrent against postmortem asset ownership controversies among family members; deterring claims of creditors and spouses; limiting personal liability for contract and tort damages; decreasing probate and estate administration costs; and minimizing guardianship costs for interests held by minors. Ownership rights in the FLLC are governed by State law as modified by the FLLC agreement.

Upon formation, family members contribute property in return for an ownership interest in the capital and profits of the FLLC.

In a partnership, the Partners or members agree who will be responsible for managing the FLLC assets and assuming personal liability for FLLC debts (“General Partner”). The personal liability of those family members who give up day to day management rights and duties (“Limited Partners”) is limited to the amount of capital which they contribute.

In a limited liability company a managing member can be appointed to control the day to day affairs of the FLLC. Unlike the General Partner, the Managing Member takes on no additional personal liability. Throughout the balance of this memo the managing partner or member shall be referred to as the “Manager”.

Many parents are not willing to part with control over their assets when the FLLC is created. In some cases the parents simply desire to continue managing their property and in other cases the children lack the maturity or business skills required to manage the assets.

The purposes for creating a FLLC are as follows:

- To adopt a succession plan for the ownership, management and control of assets.
- To ensure the orderly transfer of property interests to family members while retaining control over the assets.
- To simplify annual gifting by parents.

- To reduce income, estate, gift and/or generation skipping taxes.
- To ensure that arbitration will be the method for resolving family disputes over assets rather than costly litigation.
- To protect assets from creditors and from waste by the heirs.
- To consolidate asset ownership into a single entity.
- FLLCs are more flexible than trusts in their operation and amendment.

Manager

The Manager of the FLLC exercises exclusive control over the partnership or limited liability company business operations and determines if, when, and how much of the partnership or limited liability company income to distribute to the partners or members. As part of the FLLC's succession planning, a successor will be named to succeed in the duties of management and control upon the removal, resignation, bankruptcy, dissolution, death or incompetency of the Manager.

Possible Managers include one or both parents (or the trustee of their family living trust), another entity controlled by one or more parents, children or grandchildren (or trusts for their benefit). However, generally it is not recommended that children be given management powers unless the parents expressly desire to relinquish control over their assets and the child has sufficient experience and maturity in managing the FLLC assets.

Even though much of the value of the FLLC may be gifted away by transferring limited partnership or membership interests to the children, the Manager maintains control of the assets in the FLLC.

Duties and Responsibilities

The Manager should have the necessary willingness, knowledge and experience to do the following:

- Manage and invest partnership or limited liability company assets.
- Make decisions as to distributions of partnership or limited liability company income and/or assets.
- File income tax returns on behalf of the partnership or limited liability company.
- Furnish annual partnership or limited liability company income tax information (schedule K-1) to the partners or members.
- Make necessary filings with the Secretary of State.

- Give or withhold consent to transfers of partnership or limited liability company interests and amendment of the FLLC agreement.

Ensuring Continuous Family Ownership

Continuous family ownership of the FLLC is guaranteed by restricting each partner's ability to sell or otherwise transfer his or her interest to non-family members. Because most FLLCs are used by parents to transfer partnership or limited liability company interests to their children at reduced transfer tax values, the existence of rights of first refusal, buy-sell provisions, or other restrictions on transfer are of paramount concern and require considerable attention.

The FLLC agreement should prohibit the partners or members from selling or transferring their interests in a manner which is disruptive to the continuation of the family asset arrangement plan or disruptive to family harmony.

Typically the FLLC agreement will provide the partners or members a right of first refusal to deal with a circumstance where one partner or member wishes to sell his or her interest to a nonfamily member. In such cases the nonselling partners or members will have the right to purchase the interest of the selling partner or member for cash or with an unsecured long-term promissory note which bears an interest rate favorable to the buyer. Only if the nonselling partners or members fail to exercise their purchase rights may the interest then be sold to the non-family member.

If the family members do not wish for the new partner or member to possess any voting rights, then the agreement should permit them to treat the new partner or member as a mere assignee who is only entitled to receive income distributions and a proportionate share of partnership or limited liability company income, expenses, deductions and credits.

This mechanism provides the family members with protection from the influence of undesired active partners or members. In this way the FLLC agreement promotes continued family ownership and does not disrupt good asset management.

Reducing Values For Transfer Tax Purposes

An incidental but important benefit of a FLLC is its reduction of values for estate and gift tax purposes. Such reduction is a byproduct which accompanies indirect ownership of assets in the FLLC. As a general rule, the value of a FLLC interest is worth less than direct ownership of the same percentage interest in the underlying assets of the FLLC. This is because ownership of a FLLC interest does not convey any rights of management or control over the underlying assets (except to the Manager) and the FLLC agreement prohibits the partners or members from freely transferring their interests to non-family members. Conversely, transfer tax values are reduced by the application of discounts (determined by appraisal) to reflect these restrictions.

Partners or members who elect to implement a program of making annual gifts of FLLC interests will find that transfer tax values are lower compared to gifting assets outside the FLLC. Similarly, by holding family assets in the FLLC, estate taxes owed at death are generally lower than if undivided interests in the property are held.

Despite the reduction in value of FLLC interests, the real income production and growth potential of the FLLC's assets remain available to the partners or members since control remains within the family unit.

Discount For Lack of Control

A discount for lack of control may be applied in establishing estate and gift tax values of FLLC interests. This discount reflects the inability of a limited partner or member to control the operations of the FLLC or to invest its assets in a manner which is of greatest benefit to the limited partner or member. Because management and investment decisions (including the decision as to when to distribute partnership or limited liability company income) are outside the control and influence of the limited partners or members, the value of a limited partner or member's interest is reduced to reflect such lack of control.

Typical discounts for lack of control (minority interest) generally range between twenty percent (20%) and thirty percent (30%). This discount is sometimes referred to as a minority interest discount.

Discount For Lack of Marketability

An underlying purpose of the family limited partnership or limited liability company is to maintain ownership of assets for the benefit of members of one or more selected families. Thus, the transfer of partnership or limited liability company interests to persons outside the family unit is disfavored and, in extreme cases, may even be prohibited by the partnership or limited liability company agreement. Furthermore, private limited partnership or limited liability company interests generally lack access to a readily available exchange for trading. For this reason it is said that a limited partnership or limited liability company interest lacks marketability and is not easily convertible into cash or cash equivalents.

This circumstance has resulted in further discounts in the range of 20% to 40%.

Asset Protection

FLLCs provide a limited degree of protection for assets of the partnership or limited liability company since these assets generally cannot be directly attached to satisfy personal debts of the partners or members. Instead, the remedy of a personal creditor is to obtain a "charging order" from a court against the interest of the partner or member. The charging order entitles the creditor to receive the distributions, which would normally be paid to the partner or member until the debt is fully paid.

A charging order, however, does not give the creditor any voting rights in FLLC matters. Further, the creditor is not assured that the Manager will elect to pay out the FLLC income to the partners or members. Even though the Manager does not pay out any income to the creditor and other partners or members, the responsibility for paying the income tax attributable to the attached limited partner or member's interest will fall upon the creditor. Thus, a creditor of a limited partner or member may be persuaded to accept a lower settlement offer in satisfaction of the debt rather than pursue a charging order.

Income Tax Benefits

FLLCs also provide a number of valuable income tax benefits to the partners or members. Among these benefits are the following:

- Allows pass through of items of income, expense, credit and deduction to the partners or members.
- Permits “step-up” in income tax basis in FLLC assets for interests received from a deceased partner or member.
- Generally permits contribution, withdrawal of assets or partnership or limited liability company liquidation without recognition of taxable gain, unlike corporate ownership.
- Allows income shifting since gifted FLLC interests carry with them the responsibility for a proportionate share of the partnership or limited liability company income.

Detriments

As exists with the formation of any entity, a FLLC has some detriments. For example, the following issues will generally be encountered:

- The FLLC must file annual income tax returns and keep separate accounting records.
- Great care must be taken in contributing real property to the FLLC so that the property tax assessment property is not changed.
- The cost of formation and transferring title of assets into the FLLC.
- Transfer of Subchapter S corporation stock to a limited partnership or limited liability company will terminate the Subchapter S election.
- The IRS is challenging the use of FLLCs to achieve gift and estate tax discounts, although a number of taxpayers have settled their cases and achieved a discount.

For the most part, the detriments which accompany the use of a FLLC are heavily outweighed by its benefits and the decision to implement a FLLC should not be materially affected by these issues.

Summary

A FLLC can serve as an integral part of an estate plan and provide great flexibility in transferring assets to subsequent generations. FLLCs offer considerable tax and non-tax benefits to family members and their use should be seriously considered by those individuals having taxable estates and/or those individuals who desire to pass ownership of assets to their children without giving up immediate control over the assets.