National Business Institute:

Advantageous Use of LLCs

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September 2018

Overview of Limited Liability Companies (LLCs)

An LLC is created when one or more persons file a Certificate of Formation, similar to a certificate of limited partnership and articles of incorporation, with the Texas Secretary of State with a $300.00 filing fee.[1] The existence of the LLC begins when its certificate of organization is issued by the Secretary of State.[2] The name of an LLC must contain words or an abbreviation to designate the nature of the entity, whether the words —Limited Liability Company,‖ or —Limited Company,‖ or the acronyms LLC or LC.[3]

The LLC may be structured to be governed by Managers, who are generally equivalent to directors of a corporation, and are elected by the Members in the same manner as directors are elected by shareholders.[4] However, the LLC may also be structured so that management is performed by the Members, analogous to a close corporation or a general partnership.[5] Any —person‖ may be a Member or a Manager of an LLC.[6] Because of the broad definition of a —person‖ under the Act[7], any individual, corporation, partnership, LLC or other person may become a Member or Manager. Managers

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1 TBOC § 3.001, 4.152(1), 4.154.
2 Id., § 3.04.
3 Id., § 2.03A(1). Limited may be abbreviated as —Ltd.,‖ and Company can be shortened to —Co.‖
4 TLLCA § 2.13; TBOC §§ 101.302 – 101.304, and 101.306.
5 Id., § 2.12; TBOC §§ 1.002(51), 3.101, 101.251, 101.253, 101.302.
6 Id., §§ 2.13; TBOC §§ 101.302 - 101.304. TLLCA 4.01C; TBOC § 101.102.
7 Id., § 1.02(4). See TBOC §§ 1.001(51, 53).

may designate officers and other agents to act on behalf of the LLC.[8] The management and operation of the LLC are usually specified in a written agreement referred to as the Regulations of the LLC, which are similar to the bylaws of a corporation or a limited partnership agreement.[9] The regulations may expand or restrict the duties (including fiduciary duties) and liabilities of Members, Managers, officers, and agents of an LLC, and provide for their indemnification.[10]

If an LLC has members, managers, and officers, it may function similar to a corporation. However, one advantage of an LLC is the ability to dispense with some of the formalities required for operating a corporation, such as formal documentation of meetings, or having annual meetings.

Limited liability companies are available by statute in all 50 states, with some significant variances among state laws. An LLC must be created and filed with a state to have effect. The owner of an LLC is called a member. LLCs can either be managed by members, or by managers, who operate similarly to a board of directors. Texas allows one-member LLCs, though other states do not. In Texas, it is optional whether a member‘s interest in an LLC is reflected by a membership certificate.

By default, an LLC with two or more members is taxed as a partnership, while a single member LLC is disregarded for tax purposes, unless an election is made to be taxed as a corporation. For an LLC selected to have corporate status, a subchapter S election may be filed for members who qualify. LLCs may be treated as a corporation for corporate income tax purposes or be subject to a franchise tax like a corporation[11], unlike a limited partnership.

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[8] Id., §§ 2.12; TBOC §§ 1.002(51), 3.101, 101.251, 101.253, 101.302. TLLCA § 2.21; TBOC §§ 3.103 and 101.254.

[9] Id., § 2.09A; TBOC §§ 101.051 - 101.053.

[10] Id., § 2.20; TBOC §§ 8.002, 101.402, 101.401.

[11] In Texas, an LLC is subject to the corporate franchise tax. Tex. Tax Code Ann. § 171.001.

The advantage of an LLC is that it brings together in a single business the best features of all other business forms—a corporate-styled liability shield, and the pass-through benefits of a partnership, in which all members can participate in the management of the company without loss of protected liability status.

A member's interest in an LLC is personal property,[12] but does not confer any interest in specific LLC property[13]. Membership interest may be evidenced by a certificate if the Regulations of the LLC so provide.[14] The Act generally allows even more flexibility in structuring classes of members than is available in structuring classes of corporate stock or classes of limited partnership interests.

An LLC membership interest is ordinarily considered to be a ―security‖ for purposes of the Securities Act of 1933, and state blue sky securities laws. Thus, a sale of an interest may be required to be registered under applicable securities laws, or through a private offering, or other transaction structured to be exempt from registration requirements. LLC interests are not ―securities‖ governed by Chapter 8, Texas Business & Commerce Code, unless the interests are dealt in or traded on securities exchanges or markets, or the parties expressly agree to treat them that way.[15] Instead, such interests should be classified as ―intangibles,‖ and a security interest would be perfected by a financing statement filing.[16] Generally, assignment of an LLC interest is similar to that for assignment of a limited partnership interest, and does operate to terminate or dissolve the LLC.

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[12] Id., § 4.04; TBOC §§ 1.002(54), 101.106.
[13] Id
[14] Id., 4.05B; TBOC § 3.201.
[15] B&CC §§ 8.102, 8.103(c)
[16] B&CC §§ 9.106, 9.302(a).

Series LLCs

Series LLCs began in Delaware in 1996, arrived in Texas in 2009, and are now available in 13 states. A series LLC allows a business to hold assets and liabilities within separate cells or series which effectively operate as sub-entities. However, the series are *not* stand-alone legal entities in their own right (Tex. Bus. & Com. Code §101.622), but in many respects each series operates as if they are.

An individual series is statutorily empowered to file and defend lawsuits; enter into contracts; buy, sell and hold title to property; grant liens and security interests; and "exercise any power or privilege as necessary or appropriate to the conduct, promotion, or attainment of the business, purposes, or activities of the series." Tex. Bus. & Com. Code §101.605(5).

A series can obtain its own EIN if it chooses and be treated separately for federal tax purposes. A series may (but is not required) to have its own bank account. A series can (and should) operate under its own assumed name.

The Texas Comptroller, for its purposes, states that a "series LLC is treated as a single legal entity. It pays one filing fee and registers as one entity with the Texas Secretary of State. It files one franchise tax report as a single entity, not as a combined group, under its Texas taxpayer identification number."

The series LLC shares the advantages of a traditional LLC, including the benefit of informal management, an effective liability shield, and pass-through taxation; but a series LLC also has the ability to segregate and compartmentalize assets and liabilities within individual series. This offers significant protection and operational flexibility to the business.

Good record keeping is both important and required. In fact, series insulation is preserved only so long as "records maintained for that particular series account for the assets associated with that series separated from the other assets of the company or any other series." Tex. Bus. Orgs. Code § 101.601(b)(1). In other words, records must be maintained "in a manner so that the assets of the series can be reasonably identified by specific listing, category, type, quantity, or computational or allocational formula or procedure." Tex. Bus. Orgs. Code § 101.603(b). Implicit in the statute is the idea that assets and liabilities of a series can and should be separate both from the assets and liabilities of other series *and* those of the company at large. Commingling among these categories should be avoided.

> Generally speaking, one should not place an asset or enterprise in one series that:
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> (1) creates a much higher level of liability or potential for legal action than businesses in other series;
>
> (2) has a significantly different debt structure (involving development loans, personal guarantees, and the like) than that in other series;
>
> (3) receives significantly different tax treatment from other series or is involved in a payment plan with the IRS;
>
> (4) serves as a management entity with exposure to the public (tenants, vendors, contractors, and the like) since this function is better placed in a separate LLC altogether.

Entities with any of the foregoing characteristics should be placed in separate, stand-alone LLCs (either traditional or series), referred to among asset protection advisors as "single purpose entities" or "SPEs." Examples are restaurants, retail stores, and apartment complexes. Merely because the BOC permits entirely different enterprises to be contained within the same entity does not mean that one actually should do so.

One advantage of an LLC is that a member, unless otherwise provided, may participate in the management of the company without losing its protected limited liability status, as that member would in a limited partnership.

An LLC is treated as a stand-alone entity for contract and tort purposes. Generally, a member‘s personal assets may not be attached for an LLC debt, whether in tort or in contract. However, the protection of personal assets would not apply if the member guaranteed a debt, or committed an intentional tort. A judgment creditor, as in limited partnerships, is generally limited to a charging order against the member‘s interest.[17]

The duties of Managers (or Members in a Member-only LLC) are generally assumed to be fiduciary in nature, similar to fiduciary duties of corporate directors. The LLC statute allows company agreements to expand or restrict the duties (including fiduciary duties) and liabilities of Members, Managers, officers and other persons affiliated with the company.

How does a series LLC differ from a traditional LLC? The answer is found in one word: *exposure*. In the case of a judgment against a traditional company, *all* assets of the LLC are available for purposes of satisfying that judgment. Not so with a series LLC. If a series is sued, liability is contained within that series and does not spill over to other series or the company at large.

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[17] See discussion of charging orders in reference to a limited partnership, infra.

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A LLC may indemnify any of its Managers, Members, officers or other persons subject to the standards, if any, set forth in the certificate of formation or company operating agreement.[18] The restrictions on indemnification applying to regular corporations do not apply to a LLC.[19]

LLC Managers owe at least fiduciary duties of loyalty and care to their LLC members, although the scope of that duty may be modified by contract. If a corporation manages an LLC, then the starting point is whether the Regulations adopted impose a fiduciary duty for the

[18] TLLCA § 2.20.A; TBOC § 101.402.
[19] TBOC § 8.002(a).

corporate manager to the members of the LLC.

Even if the corporate manager of an LLC, LP, or partnership owes a fiduciary, or modified, duty to the members under the terms of the governing contract, it remains unclear whether that duty also flows to the directors of the corporation as well, although there is case law developed in Delaware to suggest that the duty may exist in the limited partnership context.[20]

A Delaware limited partner case, *In re USACafes, L.P. Litigation*[94], provides some guidance on this issue. The limited partner investors in the *USACafes* limited partnership sued the partnership, the corporate general partner, and the corporation's individual shareholders and directors for breach of fiduciary duty in authorizing the sale of the partnership's assets for a deficient price because they allegedly received substantial side payments from the buyer. The director defendants moved to dismiss the suit for failure to state a claim, arguing they owed no duty of loyalty and care to the limited partners, and that such duty was owed by the corporate general partner. The court rejected this argument, holding that ―[t]he assertion by the directors that the independent existence of the corporate general partner is inconsistent with their owing fiduciary duties directly to the limited partners is incorrect.[21] The conclusion of the court was based by analogy to trust law that one who controls property of another may not, without implied or express consent, intentionally use or dispose of that property in a way that benefits the holder of the control to the detriment of the property or its beneficial owners.[22]

The reasoning of *In re USA Cafes,* can easily be extended from the limited partnership context to other forms of partnership or an LLC, to prevent self-dealing that is detrimental to

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[20] This discussion is principally based on an article published in the ABA Journal, Vol. 12, #6 (July/Aug. 2003) authored by Victor Peterson & Alison N. Zim, entitled ―Corporate Directors, LLCs and Liability.

[21] Id., at 48.
[22] Id.

the interest of the entity being managed, or its members. Another limited partnership case, *Gotham Partners, LP v. Hallwood Realty Partners, LP*[23], reached a similar conclusion, holding that where the breach of a corporate general partner's fiduciary duties are caused by its directors and controlling shareholder, they are liable to the partnership and its members. *Kahn v. Icahn*[24], concerned a derivative suit brought by limited partners against the corporate general partner and its sole shareholder, CEO, and certain affiliates, claiming a breach of fiduciary duty by usurping business opportunities of the limited partnership. However, the limited partnership agreement permitted the general partner to compete with the business of the limited partnership, which the court concluded created a safe harbor insulating the general partner from breaching its fiduciary duties by competing with the limited partnership. In contrast, investors in *Wallace v. Wood*[99], filed a derivative suit against the corporate general partner for breach of fiduciary duty by seeking to circumvent a contractual ceiling on indebtedness for acquisitions. Following *In re USACafes,* the court held that ―officers, affiliates and parents of a general partner *may owe* fiduciary duties to limited partners if those entities control the partnership's property.[25]

If a fiduciary duty is found to exist to the members of a partnership, LP, or LLC being managed by a corporate partner, the fiduciary duties of the directors of the corporation may also conflict with the fiduciary duties owed to that entity's members. Fiduciary duties may be imputed ―upward.‖ As the court stated in *In re Monetary Groups,*[26]

> A general partner in a limited partnership stands in a fiduciary relationship with the limited partners of that limited partnership. [cites omitted] Atkins was a general partner of TSG. Thus, Atkins owed a fiduciary duty to TSG's limited partners. Additionally, TSG was a general partner of Groups. Therefore, because Atkins owed a fiduciary duty as a general partner of TSG and TSG was a

[23] 795 A.2d 1,34 (Del. Ch. 2001).
[24] 24 Del. J. Corp. L. 738, *aff'd,* 746 A.2d 276 (Del. 2000).
[25] Id. At 1178.
[26] 2 F.3d 1098, 1103 (11th Cir. 1993).

general partner of Groups, Atkins' fiduciary duty extended to Groups.

The courts may also impute fiduciary duties ―downward.‖ Delaware's Chancery Court has concluded that ―fiduciary duties may be imputed to a separate entity formed and controlled by fiduciaries for the purpose of engaging in a transaction with an entity to whom those duties are owed.[27]

In Texas, the Northern District Court recently discussed the *In re USACafes* holding. While *In re ParkCentral Global Litigation*[28] did not reject the idea of fiduciary duties flowing upward or downward, the court held that potential plaintiffs must allege specific facts that lead to a reasonable inference‖ that there is a fiduciary duty that has been breached.[29]

The basic lesson is that fiduciary duties, unlike liability to third parties for entity obligations, may not be avoided structurally by interposing entities, and claiming that the controlling members of those entities are immune from responsibility because the fiduciary duty does not flow up or down to them.

Using an LLC to Hold Real Property and Real Estate

Before LLCs gained popularity in the 1990s, limited partnerships and partnerships were the entities of choice for real estate investment. Limited partners were protected from personal liability while also being able to take pass through tax losses (subject to IRS rules) from the property. The biggest downfall with limited partnerships was that someone had to be the general partner and expose themselves to unlimited personal liability.

LLCs don't require a general partner. All LLC members have complete limited liability protection. LLCs avoid the double taxation of corporations and have complete limited liability for

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[27] *Barbieri v. Swing-N-Slide Corp.*, 1997 Del. Ch. LEXIS 9.
[28] 2010 WL 3119403 (N.D. Tex. 2010).
[29] *Id*. at *7.

all members. For holding investment real estate, the LLC is the best of all worlds when it comes to business entities.

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.

The transfer or conversion of property held in an LLC is easier than with other types of corporations. If property held in an LLC is traded in a “like-kind” exchange (in which similar properties are exchanged) or converted to personal use, there are no tax consequences. However, the IRS considers the trade or conversion of property held in a C-Corp to be a sale, which does trigger tax consequences

Multiple Entities For Multiple Properties?

The next question is how many properties per LLC should you have. Should you create one LLC and hold all your property under it, or should you create a new LLC for each property?

There are several reasons why you should consider having multiple LLCs--one for each property.

First, having multiple entities prevents "spillover" liability from one property to another. Suppose you have two properties worth $500,000 and they're held in the same LLC. If a tenant is injured at property 1, and wins a $750,000 judgment, he will be able to put a lien on BOTH properties for the entire $750,000. Even though property 2 had nothing to do with the plaintiff's injury, the plaintiff would still be able to attack that property.

On the other hand, if each property had its own LLC, then your creditor could only put a charging order lien on the property where she was injured (assuming that they cannot pierce the corporate veil).

Many banks and lenders require separate LLCs for each property. They want the property they're lending against to be "bankruptcy remote". What this means is that the lender doesn't want a problem at a separate property to jeopardize their security interest in the property that they're lending on. If they are lending money to you to buy the building on 123 Main Street, they only want exposure to risks from 123 Main Street, and not from a bunch of other properties that you own elsewhere. Therefore, lenders often insist on a new entity for the property they are lending on.

Multiple LLCs For A Single Property

You can also use multiple LLCs for a single property. In this case, you would have one LLC own title to the property, while a separate LLC managed the property--i.e. handled repairs, collected rent, paid taxes, etc. For example, if you owned the building at 123 Main Street, you could form an LLC called 123 Main Street Partners, LLC and a second entity to manage the property called Main Street Management, LLC.

You should discuss the use of multiple entities for real estate investment with your attorney or accountant. The use of multiple entities can have tax consequences that are favorable or unfavorable depending on the details of the arrangement--and only an attorney or accountant working with you can arrange the details properly.

Residential Real Estate

Also, when it comes to owning residential property in an LLC, you will frequently find that residential lenders will not lend to the LLC but will require the property to be in the individual owner's name. In some states, transferring title to and from one party to another can be quite expensive and time consuming.

In your case, you should determine what your objectives are in transferring the property to the LLC. Figure out what benefits you will get from owning the property in the LLC and then determine what your costs will be to have the property in the LLC. If your only issue is your personal liability due to an accident that could occur at the property, you might just want to get yourself a more comprehensive insurance policy that covers not only the property but also has an umbrella coverage that will cover that property and other properties you own. You might also consider increasing the limits of your coverage on your insurance policies.

When you review all of the benefits and costs, you can then make a better decision as to whether you can or want to transfer title from your name into the LLC.

Finally, in some states, when you purchase a property you obtain a title insurance policy that covers you for any loss or damage you may sustain in case the property turns out to not be yours but claimed by someone else. Among other title issues, the title insurance policy will give you some assurance that you own the property free and clear of other people's claims and rights. When you sell the property, that title insurance does not transfer to your buyer. Given your scenario, your transfer from your name to an LLC may be considered a sale and the LLC would not be protected under your title insurance policy.

If you, as a seller, transfer title in some states using a quitclaim deed, the buyer gets title to the property but does not get any rights to sue the seller in case there are any title defects. However, if you transfer title using a warranty deed, the buyer has the right to sue you for title defects. And, once you are sued, you can tender that defense to the title insurance company that insured you when you owned the property. It's a small distinction, but it gets around the issue of having to obtain a new title insurance policy when you transfer title from your name to the LLC.

Under newer title insurance policies, certain transfers will continue to be covered under the original title insurance policy. One of those transfers would be a transfer to a living trust or from one family member to another. However, generally, when you transfer the property to an LLC, the original title insurance policy may not cover the LLC unless you have the title insurance company issue an endorsement to the original policy or issue a new policy.

As for what you should do, you will need to decide that for yourself once you have gathered all the information. For some, the choice is easy and they go the route of creating an LLC because they plan to invest in many properties and create a little real estate empire. Others who will only own one or two properties often decide to hold title in their names and make sure they have great insurance.

How You Can Hold Tangible Personal Property or Intangible Assets

[to be provided by Jessica Vittorio]

Advantageously Using Valuation "Freeze" Entities to Your Advantage

Estate Freeze Technique

An *estate freeze* is a legal estate-planning technique used to lock in the current value (and tax liability) of a capital property for one person, while attributing the value of future growth of that capital property to another person. The assets are either passed through the tax system at their current value, or frozen in the hands of the senior generation at the current value, so that younger generations receive any future appreciation without exposure to gift, estate, or GST tax.

This provides taxation, estate planning and business advantages by ensuring current owners (e.g. parents) of an asset can continue to control that asset while allowing other persons (e.g.

children) to benefit from (and be liable for the taxes payable on) the increase in value of the asset after the date of the estate freeze.

Practical uses of an estate freeze include transfer of control of a privately held business between generations, deferral of the taxes payable upon the disposition of the shares of that business, income-splitting between family members and protection of assets from creditors.

Appreciating assets may be transferred from parents to their children on a tax-deferred basis, with the parents retaining control of the assets during their lifetime.

Transfer into an LLC

A transfer of property to an 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.

In its simplest form, an estate freeze transaction consists of an outright lifetime gift that appreciates in value between the date of the gift and the date of the transferor's death. The gift is factored into the transferor's estate and gift-tax exemptions and exclusions, but the appreciation is not.

Establishing the lifetime gift avoids the appreciation being subject to estate tax of potentially 45 cents on the dollar or more. Many variations on estate freeze transactions have been employed, including transferring assets to entities—such as family partnerships or limited liability companies— and utilizing these structures to facilitate the transferring of minority interests and nonmarketable units of value in order to take advantage of available valuation-discounting opportunities.

The freeze may be accomplished by forming a business entity, such as a LLC or family limited partnership (FLP), or restructuring an existing one, to provide a 1% voting share and 99%

non-voting shares. The senior family member initially retains the 1% voting share, while giving or selling the non-voting interests to junior family members-or trusts for them. The vast majority of growth in value of the assets in the entity goes to the interests held by the junior family members.

Not only does this reduce the taxable estate of the senior family member, but it can also allow for a *valuation discount* on the transfer-meaning lower taxes on the transfer of the shares. Families draft partnership agreements or other organizational documents which place certain restrictions on the ownership of the interest (shares). When given or transferred to junior family members, these restrictions reduce the appraised value of transferred shares for tax purposes, although the value of the actual assets held within the LLC or FLP does not change.

The restrictions limit transferability and control, including a lack of voting rights. This means the junior family members are not permitted to sell or transfer their partnership or member interest without the consent of all other partners or members, making them less marketable than shares of stock in a publicly traded company, which results in a valuation discount.

The valuation discounts, and resultant tax savings can be substantial, often ranging from 25% to 40%.

As late as the1980s, several court cases ruled favorably for families, permitting discounts to be recognized even when transferring interests in businesses to other family members.

Aggressive valuation discounts have caught the attention of the IRS and Congress, and this area has seen a lot of regulatory, audit and legislative activity.

In 1990, Congress enacted Internal Revenue Code section 2704 to limit valuation discounts on FLPs and LLCs being transferred to family members. Section 2704 attempted to eliminate the application of any restrictions which 1) limit the ability of the new owners to liquidate the entity (commonly known as the lack of marketability discount) and 2) lapse or can be removed unilaterally by the family after the transfer occurs.

But section 2704 never achieved its intended results because it included an exception for any restrictions required by state or federal law. Many state legislatures, in response to section 2704 updated their partnership and LLC statutes to include default limitations which would apply even if the governing documents were silent. These default state rules fell within section 2704's exception, dramatically reducing the rule's applicability to partnership and LLC transfers.

In *Pierre v. Commissioner,* the Tax Court may have finally put to rest any uncertainty as to whether a court -- for transfer tax purposes -- will look through the entity to the underlying assets to determine the situs of assets held by an LLC. Stated otherwise, at least for transfer tax purposes, the aggregate theory of partnerships appears to be finally dead.

Pierre involved a fairly typical estate tax freeze. Mrs. Pierre formed a New York LLC. Like California, New York provides that a membership interest is personal property and that a member has no direct interest in any LLC assets. Mrs. Pierre was the sole member of the LLC. Because she did not make an election, the LLC by default was treated as a disregarded entity for federal tax purposes. Contemporaneously with the creation of the LLC, Mrs. Pierre created two trusts, the "J Trust" and the "K Trust" for her son and grandchild. She then contributed $4.25 million to LLC, and shortly thereafter made gifts of 19% of her LLC membership interest to the two trusts, using her lifetime gift tax exemption to avoid the payment of gift taxes. For gift tax purposes, the membership interests were appraised and steep discounts were applied. She then sold the remaining 81% interests to the two trusts for a promissory note. The purchase price of the 81% interests was also based upon the discounted gift tax valuation.

In asserting a substantial gift tax deficiency, the IRS theory was simple and straightforward. The LLC was a disregarded entity for federal tax purposes, and disregarded means disregarded. The gift tax should have been based on the value of the underlying assets -- the cash -- and hence no discount was warranted.

One can almost sense the IRS' confidence as it girded for battle. After all, the check-the-box regulations make it clear that whether an entity is separate from its owners "is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." Moreover, the regulations provide that an unelecting single-member LLC must be treated as a disregarded entity. Mrs. Pierre, having decided to create a disregarded entity, should now be stuck with it.

A sharply-divided Tax Court disagreed. The majority held that the check-the-box regulations do not override the general rule that state law determines property rights, and New York has determined that a member of a New York LLC has no interest in the underlying assets of an LLC. Only after the rights of a member have been determined under state law does federal law determine how those property rights are taxed. In light of the fact that the check-the-box regulations (which are, after all, promulgated pursuant to a federal statute) appear to say just the opposite, the majority labored to draw a distinction between the classification of an entity, which is governed by the check-the-box regulations, and the valuation of assets, which remains governed by a state law's characterization of an asset.

Pierre v. Commissioner did not involve an NRA, but its applicability to the transfer tax liabilities of NRA's is obvious. If the IRS could not apply the aggregate theory of partnerships to impose a gift tax the underlying assets of a disregarded entity, it is not likely to successfully contend that the gift of an LLC interest by an NRA should be ignored and that the underlying U.S.-situs real estate should instead be included in an NRA's taxable estate.

A Planning Tip

All of the foregoing notwithstanding, there is a better way and a worse way for NRA's to avoid estate taxes. NRA's who plan ahead form LLC's and take title to U.S.-situs assets directly into the LLC. When the creation of the LLC and the acquisition of the assets is "old and cold," the NRA then gifts the LLC interests to the younger generation or whomever is the object of NRA's estate. Those who don't plan ahead are forced to create an LLC after the property has already been acquired by the NRA, who then transfers the property into the LLC, whose membership interests are then gifted to the beneficiaries. All of which invites the IRS to argue that a "step transaction" has occurred and that the transfer of the U.S.-situs property into the LLC in the first place was motivated purely for tax avoidance purposes. Bottom line: NRA's who don't plan and as a result pay estate taxes deserve what they get.

The Big Picture

Tax planning for NRA's would be easy if all we needed to concern ourselves with was estate taxes, especially if the real estate owned by the NRA is a non-income producing residence. But if an NRA owns an interest in income-producing U.S. real estate, the planning suddenly becomes substantially more complicated, dependent upon a myriad of tax and non-tax variables.

If an NRA owns non-income producing U.S. real estate, all we need to concern ourselves with (at least from a tax standpoint) is estate taxes on the value of the residence when the NRA dies. The NRA can easily avoid this result by taking title to the real estate in a foreign or domestic LLC and making gifts of the LLC membership interests during his or her lifetime. But the planning is more complicated if the real estate produces income. There really is no optimal manner in which an NRA should hold income-producing U.S. real estate. All of the facts and circumstances, including whether the NRA intends to sells the U.S. real estate and the country of the NRA's residence, will determine the optimal structure.

Caution:

In 2015, the Treasury Department has decided to issue new proposed regulations on its own to attempt to reinvigorate section 2704. The proposed regulations are complex, and the degree to which they will impact valuation discounts remains unclear. They involve two common valuation discounts: minority interest and lack of marketability. The new regulations, which are designed to reduce or potentially eliminate these two valuation discounts, could end up having little impact. Once effective, a grace period for additional planning under the current rules will probably not exist.

If challenged in court, it could take several years for appeals to be exhausted. It took 10 years before a court invalidated a small part of the regulations for a similar law, section 2702.

Even though we don’t know what the final regulations will say, when they become effective, or whether they will survive inevitable court litigation, its probably safe to assume that obtaining valuation discounts on family business transfers will become more difficult than it is today, which means the sooner you complete it, the better.

Even under the current regulations, the business purpose for a non-operating family entity is critical. This means finding real reasons beyond the desire for a tax break for creating a FLP or LLC to hold publicly traded securities, as an example. If the IRS believes the only reason for creating it was to take advantage of valuation discounts, it is more likely the IRS will challenge its validity.

There are legitimate non-tax reasons to create a family entity structure. For instance, to provide the younger generation with access to investments, such as private equity or hedge funds, they wouldn't qualify to have access to without the pooled family investment fund. Another example is the desire to transfer the business to the younger generation without giving up management control and the means to simplify a family's investment structures by consolidation ownership.

Examining Profitable Estate Planning Options

There are many benefits to using a LLC as part of an estate plan. The two primary benefits are to 1) "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 an LLC also reduce death taxes.

<u>Fractionalizing Property Interests</u>

When property is transferred into an 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.

Example: Joe and Shiela Smith want to give their children, Thomas and Sue, a portion of an apartment building that they own. The reason for the gifts is to reduce estate taxes at death. Joe and Shiela create a LLC with themselves and Thomas and Sue as members. Joe and Shiela 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. Joe and Shiela 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.

Valuation Discounts

When justified, minority interests in LLCs should be valued at something less than face value because the owner of a minority interest cannot realize the full value of his (pro-rata) company units if he/she were to sell them. In our example, assume Joe gifted 10 of the 500 units of the LLC to his son, Thomas. Thomas' ownership of 1/50 of the LLC is subject to a substantial discount for several reasons including:

a. A discount for lack of marketability (i.e., who would pay full value for an interest in a company owned and controlled by family members).
b. A discount for lack of free transferability as 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 in the hands of the managing member
d. A minority interest discount (for lack of control).

Typically, the terms of the LLC agreement are carefully designed to maximize the ability to take a (valuation) discount. Potentially, a discount can be taken both at the same 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.

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.

Using the Discount(s) with Annual Gifts:

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.

Using the Discount(s) at a Member's Death:

An 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/her death. For example, if a member owns 750 units each valued at $1,000 at his/her death, the deceased member's estate would include $750,000 of units with not discount. If a (combined) 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.

Holding Life Insurance Policies in an LLC

Closely held businesses often use life insurance for important business purposes, such as to fund buy-sell arrangements or provide key man coverage. The favorable income tax attributes of life insurance (e.g., inside buildup of cash value is free of income tax, as is the death benefit) often weigh heavily in the decision to utilize life insurance. However, improper beneficiary and ownership designations can have adverse, and sometimes disastrous, income or transfer tax consequences to clients. Similarly, the structure of a closely held business that owns life insurance can also produce undesirable and unanticipated results.

Problems may exist with using life insurance to fund the purchase. If the business entity holds the life insurance policies, creditors may be able to encumber the funds.

An 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. Life insurance death benefit proceeds are included in a decedent’s estate if the decedent held incidents of ownership of the policy.2 Incidents of ownership are not limited to ownership of the policy in its technical sense and can include the right of the insured to change the beneficiaries of the policy, assign the policy, pledge the policy as security or obtain a loan against the policy.

Internal Revenue Code (IRC) § 61 provides that “gross income includes all income from whatever source derived …” One exception to this general rule is found in IRC § 101(a), which provides that gross income does not include amounts received under a life insurance contract if those amounts are paid by reason of the insured’s death.

With closely held businesses, the client is often an employee and/or equity holder. In certain situations, the life insurance death benefit proceeds will be subject to income taxation. Depending on the relationship of the parties to the life insurance contract, the life insurance death benefit proceeds will be treated as compensation or dividends. In either case, the loss of the favorable income tax treatment of life insurance death benefit proceeds is costly.

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. In the case of a limited liability company, the structure of the LLC, including the rights of the members to deal with the assets of the LLC, must be such that the insured is not considered to retain any incidents of ownership of the policy, which is to be owned by the LLC.11 It should be noted that the interest in the entity owned by the insured will be included in the insured's gross estate (which could be valued, for estate tax purposes, at an amount equal to the insured partner or member's pro rata share of the underlying entity assets, including the death benefit proceeds of the policy (and any other assets of the LLC)).

> **Sample Insurance Provision/Language:** "Insurance. If the Company or any other entity with respect to which the Company has operational control owns a life insurance policy (or an interest therein) insuring the life (or joint lives [as the case may be]) of any Manager (an "Insured Manager") or possesses any incident of ownership with respect to such policy(ies), the Insured Manager has no right or power to exercise or to otherwise participate in the exercise of any of the incidents of ownership with respect to such policy(ies). Such incident of ownership shall be exercised solely by a majority of the Managers other than the Insured Manager. If no such other Manager shall then be serving, the Manager shall appoint a special Manager for the sole purpose of exercising any and all of the incidents of ownership with respect to such policy(ies)."

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/her percentage interest in the company. The use of an irrevocable life insurance trust (or ILIT) may be preferable for a number of reasons, including the greater probability that all insurance proceeds will be kept out of one's estate for estate tax purposes.

A possible solution to the problems posed by buy-sell agreements funded with life insurance recently received the blessing of the IRS in a private letter ruling (PLR). The scenario presented in the PLR, in its simplest form, involved an S corporation with three shareholders, a father and two children. The three entered into a buy-sell agreement in which each would purchase the stock of the other upon their death. Each purchased life insurance policies to fund the purchase agreement. Then, the policies were assigned to a newly formed limited liability company (LLC). Once the policies were held by the LLC, each individual contributed, over time, an amount equal to the policy premiums and, in return, received the right to receive the death benefits in proportion to the premiums paid. The father also had set up a long term, generation-skipping trust for each child. The trusts played a significant role in the father's overall estate plan and were intended to be the ultimate purchasers of the stock, rather than the child personally, to avoid attachment by the child's creditors and estate tax on the stock at the child's later death. These trusts were also members of the LLC.

The newly formed insurance LLC used in the PLR had some unique features. First, the manager of the LLC was a corporate trustee. This helped to ensure that the death proceeds were not used for an improper purpose. Additionally, the manager was instructed not to distribute any proceeds until the parties' agreed upon their application toward the cross-purchase agreement. Next, the LLC operating agreement contained special partnership accounting principles providing for two capital accounts for each member. Finally, the IRS required that the operating agreement not expressly authorize amendments by members and preclude members from voting on anything related to any of the insurance policies held by the LLC.

When life insurance is used to provide liquidity for the purchase of a deceased owner's interest, such purchase can be structured as a redemption, a cross purchase by the surviving owners, or hybrid of the two. In addition, an insurance limited liability company can also be used to maximize creditor protection and other tax benefits.

Redemption.

In a redemption, the company owns the life insurance policies insuring the lives of its owners. At an owner's death, the proceeds are paid to the company, and the company uses the proceeds to buy the interests of the deceased owner from his or her personal representative. Once the company buys the shares, the shares are no longer outstanding and the interests of the remaining owners in the company are increased proportionately. A redemption is simple and provides centralized management to administer the policies and collect the death benefits. Since the policies are owned by the company, the policies are not subject to reach by the owner's creditors, or includible in his or her estate. In addition, if an owner leaves the business, policies on the remaining owners would not be disrupted the way they would in a cross purchase (discussed further below).

While a redemption can be a simple process, consider some issues: A redemption will not increase the basis in the interests of the surviving owners, even though their proportionate interest in the company increases; however, if the buy-sell agreement is properly structured, a basis step up can be achieved if the entity is a partnership or a cash basis S corporation. Without a basis step up, any future stock sales by the surviving shareholders could result in higher capital gains taxes than what otherwise would have been incurred if the deceased shareholder's shares had been bought by cross purchase. In addition, where the entity is a C corporation, the life insurance proceeds could trigger the alternative minimum tax. Also note that life insurance policies owned by a company are subject to reach by its creditors.

Be sure to obtain proper consents on or before the issuance on any policy owned by a company that is insuring the life of a 5 percent or greater owner or a highly compensated employee. Failing to obtain these consents could cause insurance proceeds to be subject to income tax- even those proceeds that are otherwise to be received income tax free. In these instances, additional reporting is required.

Cross Purchase.

In a cross purchase, the surviving business owners (not the company) purchase the deceased owner's interest in the company. The business owners (or an insurance LLC, as discussed below) own the policies insuring each other's lives. When a business owner dies, the proceeds are paid to those surviving owners who hold one or more policies on the deceased owner, and these surviving owners buy the shares from the deceased owner's personal representative. Any shares the surviving owners buy from the deceased owner will have a basis equal to what they paid for the shares. Thus, if these shares are later sold at an amount greater than their basis, the surviving owners will recognize lower capital gains tax than the other shares they hold. Note that basis in S corporation stock or a partnership interest fluctuates from year to year, based on the company's operations and distributions. A cross purchase agreement may also avoid lender or creditor restrictions imposed on a company's cash flow, as sales of ownership interests occur between owners without company involvement.

Consider some more issues before deciding on a cross purchase: With multiple owners, a cross purchase lacks a redemption arrangement's centralized ownership and management of the policies and its proceeds. Rather, the owners individually hold policies, making the administration of these policies much more burdensome for the owners and company.

For example, policies individually held by an owner could be includible in that owner's estate should he or she pass away before the named insured on the policy. The policies may also be subject to reach by the owner's creditors. Additionally, if an owner leaves the business, it may trigger bad tax results to transfer ownership of any of insurance policies the departing owner holds on the lives of the other owners.

Hybrid.

A hybrid approach is often used where the owners want the flexibility for either the company or the surviving owners to buy a deceased owner's shares, while requiring those who receive insurance proceeds at the death of an owner to be obligated to purchase the deceased owner's shares. For example, if a company receives insurance proceeds at the death of a business owner, the company would first be required to purchase those shares whose value is equal to the insurance proceeds received, and any remaining shares could be purchased by the surviving owners or by the company. The benefits and burdens described above for cross purchases and redemptions would apply under a hybrid approach.

Insurance LLC.

When multiple owners in a business seek the benefits of a cross purchase agreement but at the same time want to avoid the risks associated with a cross purchase, they could consider forming a separate manager managed limited liability company ("insurance LLC"). This insurance LLC would hold and administer the insurance policies insuring the lives of the business owners. Since all the policies will be held by the insurance LLC and not the individual owners, the insurance LLC provides centralized management and creditor protection for the policies and avoids estate tax inclusion for its owners. It also avoids bad tax results when an owner leaves the business and policy ownership needs to be adjusted. While incorporating an insurance LLC into a buy-sell agreement can add cost and complication, an insurance LLC's benefits can often outweigh these costs.

When forming an insurance LLC, its ownership should mirror the company's, and an independent person should serve as the manager. The members of the LLC make annual capital contributions to pay premiums. At a business owner's death, the LLC's manager distributes the proceeds to those business owners who are required to purchase the deceased owner's interests under the buy-sell agreement when all of the purchase arrangements have been finalized.

Using an insurance LLC may provide business owners increased security and flexibility in buy-sell agreements. It allows an overall reduction in the number of life insurance policies needed, while increasing the likelihood that funds will be available and will be used to fund the buy-sell arrangement. These features potentially allow an insurance LLC, as used in the PLR, to play a vital role in a taxpayer's overall goal of transferring a closely-held business to subsequent generations while minimizing risks and tax consequences.