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Using a Limited Liability Company (LLC) to Transfer a Family Business

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Planning for Peace of Mind.

Most of us have at least one client who has a family-owned or closely held business that is a major part of their estate, yet they have done nothing to plan for the succession of that business. Business exit/succession planning can be challenging because of the tax issues, family dynamics and egos. But it can also be very rewarding. As we help our clients solve these issues, we develop a closer relationship with them, and we begin to build a relationship with the next generation. This planning also strengthens our professional relationships, as we must work together with other professionals to bring about the best results for our mutual clients.

In this issue of *The Wealth Counselor*, we will examine a case study that uses a Limited Liability Company (LLC) in the transfer of a family business to the next generation.

Case Study Facts

Frank (age 62) is married to Betty (age 58). Frank has an older son, Tom, from a previous marriage who is active in Frank's business. Betty has a daughter, Susan, from her previous marriage. Together they have a son, Charlie, who is a minor. Betty, Susan and Charlie are not involved in Frank's business.

Frank owns 100% of an S-corporation. It has a fair market value of $10 million and generates very good cash flow. Frank and Betty have significant other assets, including a home and investments. They own some jointly and Frank brought some into the marriage - they are held in his individual name. Their $5 million lifetime gift/estate/GSTT exemptions are fully available.

Consequences of No Planning

If Frank does nothing, according to the probate laws of the state in which they live, Betty will receive 50% of Frank's estate including the business; his son Tom will receive 25% of Frank's estate including the business; and Charlie will receive 25% of Frank's estate including the business. Because Charlie is a minor, Betty will control his share until he is 18. So, in effect, Betty will control 75% of the business if Frank dies intestate. Susan, Betty's daughter, will receive nothing.

Planning Objectives

Frank would like to ensure that ownership of the business will go to his son Tom, and Tom would like the

security of knowing that one day the business will be his. Tom does not have the cash to buy the business. Frank would also like to control the timing of the transfer of the business and he would like to treat his stepdaughter and younger son fairly. He is concerned about maintaining enough cash flow to support himself and Betty now, and providing for Betty if he dies first. And he would like to minimize estate taxes.

Recommended Plan

Phase 1: Reorganize and Recapitalize the S-Corporation

In a tax-free reorganization, the S-corporation is converted to an LLC that is taxed as an S-corporation. The LLC is organized under the laws of a "charging order only" state. Frank's ownership is changed from 100% voting shares in the corporation to 1% voting and 99% non-voting memberships in the LLC. Frank still effectively owns and controls 100% of the business, but now it is comprised of 10 LLC membership units (1%) that are voting units and 990 (99%) that are non-voting units.

Phase 2: Create Dynasty Trusts

Frank next establishes three irrevocable trusts, one for each child, in a jurisdiction that permits perpetual trusts. The trusts (irrevocable grantor trusts, aka intentionally defective grantor trusts) are disregarded by the IRS for income tax purposes, but not for estate and gift tax purposes. (Alternatively, one trust with three separate shares can be established.) The trusts are also designed to own life insurance on Frank's life.

Frank makes an initial gift of $600,000 to each trust. These are taxable gifts that must be reported on Form 709, but no gift tax will be due because it will be applied to Frank's and Betty's lifetime gift tax exclusions. $600,000 of their generation skipping transfer tax (GSTT) exclusions will also be allocated to each trust, giving each a zero inclusion ratio - so that it is not subject to GSTT in the future.

The trustee of Susan's and Charlie's trusts uses their initial gifts to purchase life insurance policies on Frank and/or Betty, providing substantial assets upon Frank's or their deaths.

Phase 3: Tom's Trust Buys All Non-Voting Units with an Installment Note

A business valuation is performed to determine the fair market value of Frank's business. As part of this process a qualified valuator first values the assets the business owns (real estate, equipment, good will, inventory, etc.). The valuator then determines whether and to what extent the value of the assets should be adjusted due to lack of control, liquidity and marketability.

When these valuation adjustments are applied to non-voting interests in an LLC, the fair market value is often depressed by a significant amount when compared to the fair market value of the entire business: in this hypothetical case, 40%. In other words, the non-voting units will each have a value of $6,000, making the total value of the 990 non-voting units $5,940,000. Alternatively, voting units will have a premium value to reflect the control value. In this hypothetical case, the voting units have an appraised value of $12,000 per unit, making the total value of the 10 voting units $120,000.

Tom's dynasty trust buys Frank's 990 non-voting units for $5,940,000 using a 20-year installment note, payable annually. Based on the current IRS published interest rates, the trust will pay Frank $447,197 every year for 20 years. The note is adequately secured by the LLC units and the $600,000 of other assets in Tom's trust. The cash flow from 99% of the business is more than sufficient to cover the note payments.

Planning Tip: The installment note should be handled just like an installment sale to a non-family member or a loan from a bank. A pledge or security agreement should be signed, required taxes should be paid, required

filings should be made, etc. A fully documented paper trail should exist for the transaction and the payments made on the note.

Why Reorganize the Corporation to an LLC?
Corporate stock is freely transferable, making it very easy for a judgment creditor to foreclose on corporate stock and become a shareholder. In most states, the percentage required for shareholder voting to liquidate a corporation is less than 100%, generally ranging from 51% to 80%. If a judgment creditor forecloses on enough shares of stock to allow the creditor to liquidate the corporation, the creditor would be able to seize the assets of the corporation to satisfy the claim.

Alternatively, LLC interests are usually not transferable without the consent of *all* members. Due to this limitation on transferability, an LLC offers much greater asset protection from creditors. Many states limit a creditor's remedy to a "charging order" on distributions to LLC members. (Only when a distribution is made will it go to the creditor; when the claim has been repaid, the charging order is stopped.) The creditor can never become a substitute member, and will only become an assignee with no ability to vote on admission of new members or the liquidation of the LLC. In most states, it takes a 100% vote of all members to liquidate an LLC. Because a creditor can never become a member, it can never vote on liquidation of the LLC.

Outcome of the Planning
Frank owns the 10 voting units, giving him 100% control of the business and 1% of the equity. Tom's dynasty trust owns 990 non-voting units, giving Tom no control over the business and 99% of the equity. Tom's trust also has $600,000 in cash that Frank gifted to it as seed capital. This cash is invested, and the income tax attributes of income, gains and losses are passed through to Frank to be reported on his tax return, as is the income, gains and losses attributable to Tom's trust's 99% ownership in the business.

Income Tax Reporting
As long as Frank is deemed the owner of Tom's dynasty trust for purposes of reporting trust income, the dynasty trust does not have to file a Form 1041 fiduciary income tax return. A corporate income tax return (1120S and K-1) is filed for the business and Frank reports the trust's income on his tax return.

Income Tax Effect of Sale of Units
Because Frank is the deemed owner of the trust for income tax purposes, the sale of the LLC units to Tom's trust is a non-recognition event; i.e., a sale by Frank to himself. No gain or loss is recognized on the sale. No interest income is recognized on the installment note payments and no interest deduction is allowed to the trust.

Planning Tip: Include a "toggle" provision to turn each dynasty trust's grantor status off or on as needed, so that the income being taxed to Frank can be stopped if that should become undesirable later. Consider giving this power to a trust protector.

Pass Through Dynasty Trust Income
Income from the LLC will be allocated to the unit holders based on their ownership percentages. Let's assume the business has $500,000 in net income. Frank owns 10 voting units, equal to 1% of the equity, so he will be allocated $5,000 on the 1120S as K-1 income. Tom's dynasty trust owns 990 non-voting units, which is equal to 99% of the equity. So Frank, on behalf of the trust, will also be allocated $495,000 on the 1120S as K-1 income.

Because the dynasty trusts are grantor trusts for income tax purposes, Frank must pay the income tax on all their income, including the S-corporation income that is allocated to Tom's trust. But that is what he was doing before the sale, so he is paying the same income tax before and after.

Planning Tip: Frank's payment of income taxes in dynasty trust income is not an additional gift to the trusts, so every year he is effectively transferring additional estate assets to the trusts for the children without additional transfer tax.

How the Dynasty Trust Makes the Required Note Payments

In this case study, we assume that the LLC will have $500,000 per year of cash flow to distribute to the unit holders. Tom's dynasty trust will receive a cash distribution of $495,000 ($500,000 times 99% = $495,000). At the end of the first year, it will have $1,095,000 in cash ($495,000 from the LLC plus $600,000 that Frank gifted to it as seed capital). The trustee uses this money to pay the $447,197 note payment to Frank.

Planning Tip: If the business does not make enough income to pay the note, the payment can be deferred until the business recovers or the term or interest rate of the note can be adjusted.

Results after One Year

At the end of the first year, the note has been reduced to $5,745,847 and Tom's trust has a cash balance of $647,803. This cash can be invested and saved, distributed to Tom (gift tax-free), or used to buy and pay for a life insurance policy on Frank's life.

Frank has received $5,000 from the LLC and $447,197 from the note payment for a total of $452,197 in income. He pays income taxes on the full $500,000 of S-corporation income. If, after all deductions, he has a 25% effective income tax rate, he would pay $125,000 in income taxes, leaving him with $327,197 in income to support his and Betty's lifestyle.

Planning Tip: A higher income tax rate means less net income, but the client can also receive additional (reasonable) compensation as an LLC manager or as a Director. If he needs less income, his salary can be reduced, but ensure that it is not so much that he loses benefits.

When Frank Dies

Frank and Betty also establish estate plans, so the assets in Frank's estate will pass as planned, not according to the state's default rules.

If Frank and Betty have consumed or gifted the net after-tax proceeds of each note payment from Tom's dynasty trust, only the unpaid balance of the note will be included in the value of his taxable estate. Tom's dynasty trust is GSTT exempt, so its assets will never be subject to estate, gift or GST taxes. Frank's estate plan leaves the 10 voting units to Tom's dynasty trust, giving Tom 100% ownership of the business. The dynasty trusts for Susan and Charlie are also GSTT exempt, and the life insurance proceeds will be exempt from probate and income, estate and GST taxes. Betty will continue to receive the remaining note payments for her support.

Estate Tax Results

Frank has removed 0.99 x $10,000,000 + 3 x $600,000 = $11,700,000 of appreciating assets from the value of his gross estate that, at his death, would have been subject to estate taxes. He and Betty have used $1,800,000 of their lifetime gift/estate/GST exemptions. (Remember, unless Congress acts before the end of 2012, the top

estate tax rate in 2013 is scheduled to go back to 55% with a $1 million exemption.)

Frank has received an asset (the $5,940,000 note) that, in his estate, may have a discounted value due to lack of marketability, etc., and that will not appreciate; in fact, the note is *depreciating* because the principal will decrease over the 20-year term.

If Frank does not accumulate the note payments, at the end of the note term he will have completely removed the $10,600,000 and all future appreciation from his gross estate without making a taxable gift other than the initial $600,000 seed capital gifts to the dynasty trusts.

The trust assets are not subject to generation-skipping transfer tax, will be protected from creditors, and will not be included in the children's or grandchildren's or great-grandchildren's gross estates at their deaths.

Objectives Met

All of Frank's objectives have been met. His son Tom will receive the business without having to buy it, and Frank can control the timing of the business transfer. He was able to provide for his other children and his wife, and he saved substantial estate taxes.

Conclusion

While this kind of planning can be complicated, the above example demonstrates that the rewards are many. We have the opportunity to help our clients solve their problems, strengthen family relationships, save money and have peace of mind. At the same time, we have the opportunity to strengthen *our* relationships with clients, their children and the other planning professionals with whom we collaborate. This type of planning is truly a win-win opportunity.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax advisor based on the taxpayer's particular circumstances.