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WHAT YOU NEED TO KNOW ABOUT LIMITED LIABILITY COMPANIES

INTRODUCTION

A limited liability company (LLC) is among the most important and popular of all the forms of entity a business may adopt.

WHAT IS AN LLC?

An LLC is a statutory business entity formed under state law. It is a hybrid of a corporation and a partnership whereby the most favorable characteristics of each are adapted to provide a unique combination of advantages and flexibility. The objective of an LLC is to receive "pass through of income, deductions, and credits" without "pass through of liability." So, the LLC is an unincorporated organization that protects its equity owners (called "members") from being personally liable for the entity's debts and obligations.

DO ALL STATES HAVE LLCs?

Yes. All states have LLC statutes. However, as noted below, in some cases these laws may differ widely in various areas.

ARE LLCs NEW?

LLCs are not new. Similar entities have existed in foreign jurisdictions for many years. International trade spurred interest in these entities which were known abroad as GmbH in Germany (check out your BMW literature) and Limitadas in Latin America. These company-type structures were organized to provide both flexibility in structure and limit the owners' liabilities.

The genesis for the first U.S. adoption, in the state of Wyoming (1977), was an oil company which had attempted to have LLC law enacted in Alaska (but failed). The company was involved in international oil and gas exploration through Panamanian limited liability companies. Then the state of Florida passed its LLC law mainly to stimulate investments by Central and South American investors who were familiar with Limitadas.

FOR WHAT PURPOSE MAY AN LLC BE FORMED?

The precise rules vary from state to state, since there is currently no uniform law to which all states must comply. Generally, the LLC must be created for either transacting business or for holding investments, or both. An LLC is formed by the filing of "Articles of Organization" (analogous to a Certificate of Partnership) with the appropriate state agency. Typically, the LLC will become effective upon filing of the proper Articles of Organization with the Secretary of State of the state in which it is to be organized.

WHAT TYPES OF ASSETS CAN BE PLACED INTO AN LLC?

Members can contribute cash, property, and in some states services (or an enforceable written promise to contribute cash, property, or services).

WHEN SHOULD AN LLC BE CONSIDERED?

An LLC should be considered when the parties want to:

- (1) Create a flexible entity which provides limited liability for its members,
- (2) Create a "flow through" organization for federal income tax purposes,
- (3) Stimulate investments by investors familiar with LLC type organizations, and
- (4) Obtain a number of estate planning objectives.

Professionals often operate their practices as LLCs to limit their liability for the negligence of others in the practice, while obtaining the favorable taxation available to partners.

WHAT IS A CLASSIC CLIENT PROFILE?

Typically, the person who sets up an LLC will be in his or her late 30's to mid-50's or older, married, with several children and/or grandchildren, has an estate in excess of \$3,000,000 (aside from his or her principal residence and life insurance), and business interests and/or real estate holdings that are appreciating in value.

The individual will probably be a professional (CPA, physician, attorney), or an entrepreneur in business with one or more active investors (including family members). He or she may also be an investor in a high technology business, real estate or oil and gas investment, or other risky joint ventures. Debt offerings and structured finance are also indications that an LLC should be considered.

Wealthy ("investment" estates of \$2,000,000 or more), single (divorced, widowed, never-been-married) individuals, who are concerned about transferring wealth to someone other than (or in addition to) a charity and are extremely conscious of liability, may find an LLC very appealing.

LLCs are particularly attractive to foreign investors from Germany or South America, since these countries have similar laws.

Here is an example: Steve and Howard decide to do business together, but both are worried about liability, and both would like to take the early losses of the business and apply them against taxable income each anticipates from other sources. Both men contribute cash, some property, and their services; and in return each receives a membership in the organization. The profits and losses of their business as well as any cash and property distributions to the two men will be apportioned according to the relative value of their contributions, unless they have provided some different allocation in their operational agreement. They file documents with the appropriate state agency in their state for LLC status.

WHAT ARE THE CHARACTERISTICS OF AN LLC?

Some standard (but not universal) traits of these creatures of state statutes are:

- Although most states permit one-member LLCs, an LLC typically consists of at least two members. But unlike S corporations, there is no statutory limit to the number of members an LLC may have.
- Members receive "interests" or "units" (just like partners have interests or units in a partnership) but do not receive shares of stock.

- Managers (who can be either members (owners) or non-owners, and can be individuals, corporations, partnerships, or other LLCs) are essentially the same as a corporation's board of directors. These managers oversee the long-term goals and operations of the business if that governance mandate is given by the LLC members. In other words, members can retain the right to vote in accordance with their proportionate interests or, as is more often the case, when there are five or more members, they can designate an inside or outside party to act as a manager (with more or less operational powers of a general partner).
- If an LLC is member-managed, each member has – in effect – many of the powers of a general partner. If an LLC is run by a member-appointed “operating manager” then individual members, unlike partners in a partnership, cannot act on behalf of the LLC (without express agency authority).
- Distributions are made and profits and losses are allocated proportionately by reference to the respective contributions of the members.
- All members and managers are protected from “personal liability” for the LLC's debts and other obligations. In other words, the limit of liability in an LLC is the extent of a member's investment. Neither members nor managers can be held personally liable for LLC's debts or liabilities they have not personally and specifically agreed to accept – with two minor exceptions: First, members will be liable for any unpaid capital contributions. Second, members may have to make up deficits that occur if an LLC makes distributions in excess of its assets.
- Members may freely assign or transfer the economic rights associated with their interests (unless a buy-sell or other restrictive agreement provides otherwise). This does not mean that the assignee of the interest automatically becomes a member, or is entitled to vote or exercise other rights of membership, such as governance management or operations. It implies only that the recipient of the interest is entitled to receive the transferor's share of any distributions. Of course, if the other members agree to the membership (either all members, or in some states a majority of the members present, must vote positively to accept an assignee as a member), then the assignee can become one.
- Rights (other than economic rights) can only be assigned with the consent of other members. If a member does assign rights, the assignee would only receive the right to those distributions and allocations which the assignor would have received.
- Members in LLCs, just as partners in partnerships, have no rights to specific assets owned by the entity.

- The LLC entity typically dissolves upon the first to occur of:
 - (a) unanimous consent of all members,
 - (b) the date or occurrence specified in the Articles of Organization or Operating Agreement (often 30 years),
 - (c) voluntary withdrawal of a member,
 - (d) death of a member,
 - (e) expulsion of a member,
 - (f) bankruptcy of a member, or
 - (g) a decree of court holding that it is not reasonably practical to carry on the firm's business in conformance with its operating agreement.

Of course, the entity may also dissolve upon the occurrence of an event (such as loss of license), which would terminate a member's continued ability to actively participate in the affairs of the business.

However, the business of the LLC can be continued by unanimous consent of the remaining members in spite of any of these events.

- The entity can conduct almost any type of business that has not specifically been prohibited by state law. It is important to check, since a few states allow LLCs only in the fields of insurance, banking, or to provide professional services, while others prohibit LLCs from rendering professional services and/or engage in banking or insurance business, and at least two states prohibit the use of LLCs for holding farmland.
- An LLC's Operational Agreement, similar to a Partnership Agreement, states the terms upon which the organization will do business and the relationship of the members. The agreement must be signed by all members and, unless the agreement provides to the contrary, can only be modified by unanimous vote of the members. So an LLC begins when its members file an "Articles of Organization" with the appropriate state agency. Then, its daily affairs are governed by an "Operational Agreement" among members comparable to the by-laws of a corporation.
- Members can typically resign after giving six months' notice (unless the agreement provides otherwise). At that time, the LLC must distribute cash, assets, or both, with a fair market value equal to the member's interest within a reasonable time. This, of course, is both an advantage (from a member's liquidity and security viewpoint) and a disadvantage (from the firm's liquidity viewpoint, and also reduces any valuation "discount" adjustment for gift tax purposes).

- Distributions are prohibited to the extent that it would render the LLC “insolvent.” Some LLC statutes impose personal liability on members who approve improper distributions.

WHAT ARE THE BENEFITS OF AN LLC?

There are many potential benefits of operating in LLC form. These include:

Protection against creditors: Creditor protection is the single, most important and obvious characteristic of the LLC, and is a key factor distinguishing an LLC from a partnership which provides limited liability only for limited partners but not its general partners. It is also the characteristic which makes LLCs similar to corporations. Note that the LLC is the only business entity that allows every member, including managers, to enjoy limited liability while the entity is treated as a partnership for federal income tax purposes. This insulation is particularly important if the underlying business or asset may involve environmental claims, product liability claims, or similar exposure. However, it is important to emphasize again that lenders, such as banks, will often require the personal guarantees of senior family members (deep pockets) and, to that extent, the utility of legal limits on liability is lessened.

Management without personal liability: Unlike partners in a limited partnership, any member of an LLC can be involved in management without incurring personal liability – therefore, an LLC is very appealing to senior family members. Compare this benefit of limited personal liability with the fact that partners in a partnership who exercise control and participate in management decisions can be cast as general partners and, as a result, be exposed to liability for the partnership's debts and liabilities.

It is important, however, to note that the limitation of liability has its own limits. An individual member of an LLC is not protected from his or her own tortious conduct and this may make the protection illusory, to the extent an owner actually works for the entity. Furthermore, as noted above, the LLC may be required to contractually give up some of its limitation on liability in order to do business with certain parties, and senior family members may have to sign personal guarantees for the LLC's performance. Managers of an LLC have certain fiduciary duties to members and can be sued for breach of such responsibilities. And some states do not extend limited liability to professionals, such as doctors, lawyers, or accountants, for malpractice committed by the professional or an individual under the control of that professional.

Family business and estate planning tool: Because an LLC can be (and generally is) structured to be taxed under partnership laws, it has many of the same features of a partnership used in business and estate planning, including:

- Avoidance of double taxation at the entity level. Since income is taxed directly to members (including those who are not active in the business), the LLC can be used to help shift income to family members who cannot or do not want to work in the business.

- Interests in a family LLC can be shifted to other family members with little physical or financial cost. This makes wealth-sharing among family members relatively easy to accomplish.
- Because many states have highly flexible LLC laws, a great deal of planning objectives can be achieved. For example, an LLC may be set up to provide different preferences in asset distribution, and different voting rights for different groups or classes of members. In my opinion, this is one of the most important advantages of an LLC. An LLC can set up "preferred interests," special allocations, or almost any other form of economic or management relationship desired. This makes it possible to satisfy the different objectives for various family members, or meet widely divergent needs or circumstances.

Economies of scale: An LLC can serve as a vehicle to consolidate the management of a client's assets. For example, if the client were to give an asset to each of his two children – there would be no certainty that the value of each asset would grow at the same rate, nor would the income generated be the same for each child – and the client would also incur multiple administration or management fees. Instead, a centralized management (either the client or the person or party the client appointed to manage the LLC) could be used to handle all the assets uniformly, and the children would share equitably in both the growth and income from all the assets. In a sense, an LLC can serve, to some extent, as an alternative for a total return unitrust (TRU).

Avoidance of ancillary administration: An LLC interest is personal property even if the LLC holds only real estate. Real property can be "converted" to personal property through an LLC, thus, avoiding probate in the state where the real property is sited. For instance, by titling property in New Jersey, Florida, and Pennsylvania in an LLC, the members' interests become personal property and are probated under the laws of the state in which the member is domiciled – rather than in each of the multiple states in which the properties are located. Avoidance of ancillary probate can save significant aggravation, delays and expenses.

Pass through of losses: If the LLC qualifies as a partnership for federal income tax purposes, losses generated at the entity level can be passed through to the personal returns of the members. (However, planners should remember that such loss deductions may be limited by "at-risk" rules, basis limitation rules, or by passive activity rules.)

Another advantage of pass-through taxation is that when assets are distributed upon a liquidation of the business, there is no tax at the entity level. This is not the case for corporations, which now must treat a distribution of assets in liquidation as if the assets had been sold by the corporation first and then distributed (resulting in a double taxation).

Ability to make special allocations: The ability to allocate LLC income, gain, loss, credits, and deductions among the various members is one of the most important "income shifting" benefits of LLC status. Tax law requires only that this allocation have "substantial economic effect."

Cross-Border Investments: An LLC may be an attractive alternative to traditional forms of vehicles historically preferred by foreign investors for investments in or through United States entities. Similarly, an LLC formed under the laws of a foreign country may be an attractive investment or business vehicle for U.S. taxpayers. The planning opportunities are enhanced by the opportunity to form an LLC that will be treated as a corporation under the tax and liability-protection laws of one jurisdiction but will be treated as a partnership for U.S. federal income tax purposes.

Potential multiple gift/estate tax valuation discounts: As soon as cash, stocks, real estate, a business, or any other asset is placed within the wrapper of an LLC, its utility to the typical buyer diminishes. This reduction in the marketability leads to a valuation discount that can be both realistic and reasonable.

Furthermore, if the entire LLC is fragmented into pieces and control rests not with donee recipient family members but with the manager member older generation client, those donees will have little say in cash flow or liquidation decisions. This leads to yet a second level of discount. Together, the lack of marketability and the lack of control may result in a discount in excess of 10 percent. Shifting wealth and splitting income become more cost-effective when such discounts are available. Note, however, that numerous factors – particularly the ability of a member to “cash out” of an LLC – serve to reduce the transfer tax valuation discount to well below what it might be in the case of a partnership interest. Lastly, too much control vested in the hands of the senior family member may lead to estate tax inclusion. These issues are discussed in detail below under “Downsides.”

Suitability to joint ventures: In most states, a non-professional cannot be a partner of a professional corporation. For instance, an attorney cannot be a partner of a CPA firm. Yet, many professional firms are spinning off into separate business units, and want to attract key individuals with other professional skills and designations. An LLC may be an ideal choice for a joint venture, because the entity is taxed as if it were a partnership, the parties have liability protection, and each can participate in the LLC’s major business decisions, even if not all members are of the same profession.

Project financing facilitated: Outside investors (including institutions) are more likely to make equity contributions to an organization that provides partnership income-tax treatment while accorded with liability protection. An outside investor could achieve these two goals by placing one or more individuals into the management of the LLC and, thus obtain a significant degree of business and financial control. This would not be possible if the outside investor had to become a general partner or a limited partner in a partnership.

Another dimension is that debt arrangements can be much more flexible with an LLC (or partnership) than when a C or S corporation issues it. If a shareholder loans money to the corporation, the IRS might recharacterize the loan as equity for income tax purposes. The payments to the shareholder might be treated as dividends, rather than interest or tax-free recovery of capital (although the reduction of the tax rate on dividends significantly alleviates this problem, and in some cases may even suggest deliberate dividend planning). The problem is even more severe if the corporation has elected S status since the entity could lose its S election if the distribution is considered a second class of stock.

The LLC could provide varying distribution rights with respect to the timing, amount, and source to its members.

Applicability of partnership compliance procedures: Federal tax compliance has proceeded relatively smoothly, because the IRS has essentially treated LLCs as partnerships for income tax purposes and used the established body of laws in that area as guideline.

In-kind distribution: An LLC can distribute appreciated property and realize no taxable gain at the entity level. Assuming members have enough basis to absorb the distribution, they will not have to report the gain either.

Ownership flexibility: Unlike S corporations, any person, group of people, or any legal entity can own an interest in an LLC. This means a charity, certain trusts, a qualified retirement plan, C corporation, partnership, or even another LLC can own an interest. This makes it possible to achieve a number of otherwise difficult or impossible planning objectives.

WHAT ARE SOME OF THE DOWNSIDES TO LLCs?

Every tool or technique has downsides and costs. LLCs are no exception. Among their downsides are:

Relative Lack of track record: There are relatively few regulations, rulings, or cases on LLCs as entities (in comparison to partnerships and/or corporations), and even fewer on its use as a tool, or on the techniques associated with it for wealth transfer planning.

Potential liquidity problem: Most states require an LLC to buy the interest from any member who desires to leave with very little notice (six months is typical), the LLC could find itself short on cash or operating assets – when a member leaves at a financially inconvenient (or even disastrous) time. In a state which does not allow the LLC to block the voluntary departure of a member, this could jeopardize its very existence.

Potential involuntary dissolution: A dissident family member could force dissolution upon the death, bankruptcy, etc. of a member since a unanimous or, in some cases, majority consent of the members is necessary for the LLC's continuance.

Potential disallowance or reduction of gift/estate tax valuation discount: As noted above, a valuation discount on a gift or bequest of an interest in an LLC may be denied or significantly reduced:

- (1) Because the dissolution rules make it possible for a member to reach his or her share of the LLC's underlying assets (unlike the case in an FLP or other forms of family business entity).

According to this theory, the IRS might significantly reduce a valuation discount and argue that the basis of transfer tax valuation more closely approximates the firm's net asset (liquidation) value.

In other words, it may be difficult to claim a sizeable discount on the grounds that there is an entity standing between the members and their assets, since under the dissolution rules the termination of the LLC is automatic upon a triggering event (unless a majority or unanimous vote to continue is made).

- (2) Partnership anti-abuse regulations make it clear the IRS will deny partnership income tax status to any entity which does not have a substantial business or investment purpose, or meet state law requirements. At the very least, it will deny a minority interest discount for a transfer of an interest. For example, if a husband and wife form an LLC to hold their vacation home, art collection, and life insurance on their lives. In my opinion, the IRS will deny the minority interest discount on the basis that the entity is neither transacting business, nor does it have a substantial investment purpose. Even, if the LLC is formed to manage income-producing real estate, if the client immediately transfers interests to her children – before any significant activity occurs in the entity – the IRS may attempt to disallow any valuation discount.

Taxation of fringe benefits: Some otherwise nontaxable fringe benefits are not excludible from the income of members because members (like partners in partnerships) are not considered “employees.” These benefits include medical benefits, cafeteria-plans, some meals and lodging, and group term life insurance. (Of course, these same rules apply to owners of partnerships and S corporations.)

Expense: LLCs require a partnership type agreement which can be complex and expensive to draft. Compare this with the creation of S corporations which can be set up with much less expense.

Conversion costs: A business currently existing in corporate form which has appreciated assets such as buildings, equipment, and inventory can not be converted to an LLC without realizing a gain on the increase in value of the assets over their basis, a cost many clients would be unwilling to bear.

Too much control results in adverse tax consequences: At the point where the client insists on “too much” control, either the income or the assets (or both) will be treated as having been retained. The client could be taxed on the entity's income, and the assets held by the LLC could be included in his or her estate.

Non-transferability hinders marketability: Some investors demand the ability to cash-out of an investment almost instantaneously, and trade ownership interests freely. The lack of free transferability in an LLC would diminish the appeal to such investors.

State reporting and annual fee requirements: Many states require LLCs to file annual reports and pay annual fees. These fees will vary from state to state.

State franchise tax: Conversion to LLC status may expose the firm to a state's franchise or corporate income tax.

State restrictions on purpose: Some states restrict the purpose for which an LLC may be formed. For example, insurance companies, banks, professional services, farms and ranching businesses may be prohibited from forming LLCs. Some states may require a "business" purpose (i.e. an entity with an objective of carrying on a business and sharing profits). This may thwart some LLCs intended as investment vehicles.

Self-Employment tax: Members of an LLC who actively participate in the business engaged in by the LLC must pay self-employment taxes on their distributive shares of income. But other members may be accorded treatment as a limited partner (and thus excluded from the necessity to pay self-employment tax) if certain criterion are met.

SUMMARY

Although relatively new, LLCs are already highly important as a form of business and investment vehicle that should be considered for wealth management and transfer purposes, as well as for business planning when forming a new entity.

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