Many families select a trust in order to avoid estate taxes, manage assets, and provide that the assets pass to later generations. In some situations, a family limited liability company (“FLIC”) may be a superior vehicle for managing assets and ensuring that they are kept within the family.

Let’s look at an example: Mom and Dad own a 200-unit apartment complex and a beach house, and they want both to pass on to their children. Their three children range in age from 17 to 27. Although they are good kids, they don’t always agree on everything and are not experienced in running a business. Mom and Dad are considering establishing a trust or a FLIC to manage these two assets following their death. What are the considerations?

Management

For an apartment complex of this size, a management company should be hired to provide day-to-day management. But the management of the manager and making decisions about major matters such as sale, financing, refinancing, and major property improvements or repairs should be handled at the ownership level. For the beach house, sticky questions, such as who gets the beach house on July 4, whether the owners can bring pets, and how to pay for operating expenses, should be resolved by the owners.

The person making ownership decisions for a trust is generally the trustee. For a FLIC, it generally is the member-manager of the FLIC. In either case, Mom and Dad could, through the trust agreement or the FLIC’s operating agreement, select a manager or trustee and that person’s successors. Mom and Dad could also name successor managers or trustees, or they could give the trustee and manager the right to appoint their successors. When the children mature to a point at which they can participate in management, they too can be appointed as trustees or FLIC managers. If the three children are the managers, the FLIC’s operating agreement can allow a majority vote to determine whether a particular action should be taken.

A trust can also split control and allow the beneficiary, and not the trustee, the right to make certain major decisions. Typically, this would include a decision to sell a major property or use it as collateral to secure a loan. Such rights can spring into existence when the youngest child is age 25, for example.

Keeping It Within the Family

The trust can pass on the beneficial ownership of the asset following the death of a child to that child’s children. A trust agreement generally provides that as each child dies, his or her interest passes to the grandchildren. Typically in a FLIC, each child can pass on his or her interest to only family members as well, but the child can select whom it should pass to. Thus, the child can pass the interest to a spouse, if allowed in the FLIC’s operating agreement, to siblings, or to the child’s children. But the decision about to whom to transfer the interest within the class of permissible transferees rests with the owner.

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Today we discuss the essential elements of a plan that owners use to transfer a business to insiders (children, key employees, or both), with the help of skilled advisors. A good plan will keep the owner in control until he or she is paid the sale price, if a transfer price is negotiated. Even if there is no sale component (in a transfer to children, for example), we believe you will still want to consider the following ten elements that can help make insider transfers more successful.

Element 1: Time

A transfer to insiders takes time—to plan, to implement, and to pay the departing owner. Typically, the more time owners take to plan and execute the transfer of their companies, the less risk they incur and the more money they receive from the new owners.

For that reason, the first question that an owner must answer is: Am I willing to take time (typically three to eight years) to execute and complete an insider transfer (while maintaining control)? If the answer is no, then it is probably best to consider other exit paths.

Element 2: Defined Owner Objectives

If owners are willing to devote the time necessary, they also should clearly define their objectives. These may include:

- Personal financial security and independence (from the business);
- Departure/retirement by a chosen date;
- Keeping the family legacy or company culture intact;
- Rewarding key employees; or
- Taking the business to the next level—at someone else’s risk.

In a well-designed transfer plan, many of these objectives are met before control is transferred.

Element 3: Cash Flow

Healthy cash flow is critical to any insider transfer. No one (whether an outside third party or an insider) wants to assume responsibility for a company with anemic cash flow. In a transfer to insiders, however, cash flow assumes even greater importance, because it is likely to be the major, if not sole, source of the owner’s future financial security.

Element 4: Growth in Business Value

In addition to healthy cash flow, new owners look (and pay top dollar) for companies that have the potential to grow in value. In transfers to insiders, only if cash flow continues to grow does the ownership transfer generally culminate successfully. For this reason, it is vitally important that owners contemplating an insider transfer install and cultivate components that help ensure positive cash flow and cash-flow growth before and during their exit transition.

Element 5: Capable Management Desiring Ownership

Having a motivated management team in place and capable of replacing you is hugely valuable. In a transfer to insiders, this is essential. The management team must also desire ownership and be willing to sign personally for any acquisition financing or ongoing company debt. Owners often assume that their management teams want to own their companies, and they do—but sometimes they do not realize that personal financial responsibility accompanies ownership.

Element 6: Minimize Taxes

While no owner we know wants to pay more tax than absolutely necessary, those contemplating insider transfers generally focus on minimizing taxes for all the parties involved. In an insider transfer, it is imperative that the owner, with the help of competent advisors, structure the sale to minimize taxes on the company’s cash flow (pretax income) and, if possible, the new owners, as well as on themselves, because without planning the cash flow is likely to be taxed twice:

- once when the insider receives it (as the new owner), before paying you for the purchase; and
- again when you (the existing owner) pay taxes on the proceeds you receive.

One goal of tax planning in an insider transition plan is to subject the company’s cash flow to taxation only once. Accomplishing this feat takes considerable planning, but it is worth the time and trouble to save a third or more of the company’s cash flow from this type of double taxation. One-time taxation means that owners receive more money more quickly, and thereby reduce the risk of nonpayment, and that the new owners are able to have Uncle Sam help make the payments, through reduced tax structure.

Element 7: Regulate an Incremental Transfer of Ownership

One of the most important advantages of the well-designed insider transfer plan is that it gives the owner the ability to regulate how ownership is transferred, when it is transferred, and how much ownership is transferred. If company performance falters, employees stumble, or the owner chooses instead to sell to a third party, the well-designed insider exit plan keeps the owner in the driver’s seat.

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Most of us have heard by now that the United States Supreme Court struck down Section 3 of the Defense of Marriage Act ("DOMA") this summer, holding unconstitutional a provision that defined marriage as a legal union between one man and one woman for the purposes of federal law. Until a recently issued revenue ruling from the IRS, however, exactly what the Supreme Court's decision would mean for federal tax law as applied to same-sex couples was unclear.

Edith Windsor and Thea Spyer were residents of New York and were lawfully married in Canada. When Ms. Spyer died in 2009, Ms. Windsor sought to claim the exemption from federal estate taxes that a surviving spouse would have received, but because of Section 3 of DOMA (which defines the term "spouse" as applicable to only opposite-sex marriages), Windsor's claim was denied. The IRS found that the exemption from federal estate tax afforded to opposite-sex spouses did not apply to same-sex spouses, and Ms. Windsor was compelled to pay $363,053 in estate taxes.

The Court's decision in United States v. Windsor meant that same-sex couples living in a state that recognized their marriage would be able to avail themselves of all the federal benefits afforded to married couples, including filing joint income tax returns, qualifying for social security survivor benefits, making unlimited interspousal gifts or bequests without federal gift or estate tax, and taking advantage of a "spousal rollover" IRA after the first spouse dies.

Before the IRS issued guidance in the form of the recent revenue ruling, however, it was unclear what effect the Windsor case would have on the application of federal law for taxpayers residing in states that do not recognize same-sex marriage. Significant questions remained regarding whether the IRS's recognition of a marriage would be tied to whether a couple's state of residence recognized same-sex marriage and, if so, what implications that would have for taxpayers who crossed state lines to marry. The IRS unambiguously answered this question, stating that "individuals of the same sex will be considered to be lawfully married under the [Internal Revenue] Code as long as they were married in a state whose laws authorize the marriage of two individuals of the same sex, even if they are domiciled in a state that does not recognize the validity of same-sex marriages." Thus, an Oregon couple who travels to Washington to marry and returns to reside in Oregon will still be recognized as a married couple for federal tax purposes, regardless of whether Oregon recognizes the union.

The revenue ruling cleared up another area of uncertainty by confirming that the term "marriage" will not be applied to domestic partnerships, civil unions, or other similar types of relationships recognized by state law.

The revenue ruling also states that taxpayers may file amended or adjusted returns based on this change, as long as the statute of limitations does not bar the filing. This means that lawfully married same-sex couples who had previously been unable to file jointly may now file amended returns.

In light of these recent developments, same-sex married couples who did their estate planning on the assumption that they would not be accorded the same federal estate tax benefits as opposite-sex couples may want to speak to an attorney to see whether a revision in their plans is advisable.
In the last issue, we took a look at the general advantages of using a limited liability company (“LLC”) as part of a broader estate planning strategy, with a specific focus on the potential impact of valuation discounts on transfers of LLC interests. In this installment, we will continue to look at the roles that an LLC can play, looking particularly at using an LLC to hold out-of-state real property.

Why Use an LLC to Hold Out-of-State Real Property?

To understand the utility of an LLC in this arena, a basic understanding of probate is required. Probate is the process by which a court supervises the transfer of a decedent’s assets at death. Because real property is subject to the jurisdiction of the state in which it is located, real property must generally be probated in that state. Going through this probate process in a state that wasn’t the decedent’s state of residence is often called “ancillary probate.”

This can pose a major inconvenience for people who own real property in multiple states, and there are several ways of circumventing the need for ancillary probate. One common way is to create a revocable (“living”) trust; another way is to create an LLC and transfer ownership of the out-of-state property into that LLC.

How It Works

Creating an LLC and transferring real property located in multiple states to that entity sidesteps the need for an ancillary probate in each state in which the LLC holds property. After the decedent’s death, the LLC will continue to hold the real property, and therefore there is no need for a court-supervised transfer. The decedent’s membership interest in the LLC will pass to his or her heirs, but this will require a probate only in the decedent’s state of residence, and not in every state in which the LLC holds property.

Considerations Beyond Avoiding Probate

While the process described above does circumvent the need for ancillary probate, avoiding probate is not necessarily the only consideration at play. One major consideration that varies by state is the estate tax consequences of holding property in an LLC versus holding it outright.

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A state in which real property is located will have the authority to tax the transfer of that real property upon the decedent’s death. For example, if a Washington resident owns real property in another state, that other state will likely levy a tax on the value of the real property at the decedent’s death. If that real property is held in a Washington LLC, however, the state in which the property is located will not have the right to impose state estate tax on the transfer of those LLC interests at the decedent’s death.

In Washington, out-of-state real estate is not subject to Washington State estate tax. Therefore, any out-of-state property owned by a Washington resident at death will not be taxed as part of that resident’s estate for Washington estate tax purposes (it will be subject to federal estate tax). Because LLC membership interest is classified as “personal property” for tax purposes, however, moving real estate into an LLC means that the value of the real estate (expressed as membership interest in the LLC) would be included in a Washington resident’s taxable estate, even if the property held by the LLC is out of state.

The same is true in Oregon, but the value of out-of-state property will be used to calculate the rate at which Oregon estate tax is imposed (meaning that those owning out-of-state property will be taxed at a higher rate than they would have been if such property was not part of their estate, though the out-of-state property itself will not be subject to tax).

Conclusion

Using an LLC to hold out-of-state property can have many advantages—it can avoid ancillary probate as discussed above, and it can facilitate the transfer of one parcel to multiple heirs without dividing the property, as discussed in our prior column on this topic. As with any estate planning strategy, however, the usefulness of LLCs should be carefully weighed with the potential disadvantages in order to produce the best result.
of the FLIC interest. This might mean, for example, that a parent could pass on more assets to the child who has the greatest need for those assets. This can be done with a trust as well, through a power of appointment, which can be exercisable during the child’s lifetime or only at death.

Most trusts strictly prohibit, in a provision called a spendthrift clause, the right of a beneficiary to in any way transfer or borrow against his or her interest in the trust. A FLIC can also prohibit or greatly restrict the rights of its members to sell, gift, or pledge the membership interest. But a spendthrift clause in a trust can defeat a judgment creditor, while a judgment creditor can reach a member’s ownership interest in a FLIC.

**Distributions of Principal and Income**

For a trust, the trustee generally has the power to distribute trust income and principal to the beneficiaries. For example, a trustee might have the power to give money to one child to establish a business, while making no distribution to a second child who has a substance-abuse problem. For a FLIC, while it is technically possible for the manager to make such distinctions, generally the manager has the power only to make distributions to all the FLIC members on a pro rata basis based on each child’s ownership percentage. But the FLIC manager can withhold distributions, except for any amounts needed to pay taxes, and invest the FLIC’s cash assets in stocks and bonds instead of distributing the assets.

**Flexibility**

So far, one can see that both a trust and a FLIC have their advantages and disadvantages. But one area that may favor a FLIC is its flexibility. A FLIC can be amended based on rules set forth in its operating agreement. Typically a majority, or perhaps two-thirds of the members, can revise the agreement. The operating agreement could provide that the right to vote to amend the agreement will not exist until the children reach a particular age. A limitation on the flexibility of a FLIC is that all the members of the FLIC must be at least 18 years of age because it is essentially a contract. Thus, a 17-year-old child would need to have his or her interest held in trust or possibly a Uniform Transfers to Minors Act account at least until reaching age 18.

While such a power could be given to children in a trust, it would be very unusual. Trusts designed to manage assets for children are typically irrevocable. It is not at all unusual after an irrevocable trust has been created that Mom and Dad desire to revise the trust because of a change in circumstances. While an irrevocable trust can be modified, it generally requires going through a complex process, which might include obtaining court approval and unanimous approval of the beneficiaries. So a FLIC can offer more flexibility than a trust.

**Transfer Taxes**

A trust that is used to manage assets can be established to avoid estate taxes and generation-skipping taxes (typically, a tax on transfers to grandchildren) on its assets on the death of the children, provided that the property remains in trust for the entire lives of the children. But a child will not be subject to estate taxes until his or her estate exceeds $5,25 million. That number jumps to $10.5 million for most married children. So for the overwhelming majority of families, avoiding transfer taxes on the death of children is not an issue. If it is an issue, an irrevocable trust designed to save estate taxes and generation-skipping taxes on the death of the children may be the right answer.

**Income Taxes**

A FLIC has a big advantage because it will generally save significant income taxes. A trust starts paying taxes at the highest federal tax rate of 39.6 percent on $11,950 of income that is not distributed to its beneficiaries. FLICs do not pay income taxes. A FLIC’s owners are taxed on all the income, which will be taxed at the highest federal tax rate of 39.6 percent starting when an owner’s total income reaches $400,000. Likewise, the new 3.8 percent tax on certain investment income will kick in much earlier for a trust that does not distribute all its income. Further, assets in a typical irrevocable trust held for children until death do not receive a step-up in tax basis. Assets held in a FLIC, however, do receive a step-up in basis at death, and the FLIC’s operating agreement can even provide that the heirs have the right to higher depreciation and lower capital gains taxes based on the stepped-up basis of their share of the FLIC’s taxable income.

**Conclusion**

While a trust and a FLIC each have their own advantages and disadvantages, a FLIC may be the big winner in the areas of income-tax saving and flexibility. Further, Mom and Dad might see a FLIC as a more natural way to involve mature, adult children in the ownership and management of assets. Note also that this brief article does not cover every issue in what can be a very complex area. And it is not a substitute for a thorough discussion of the issues with your advisors.
Element 8: Increase Control = Decrease Risk

While business owners take risks every day, they do not relish risking their own and their families’ future financial security in what should be their one and only exit. Therefore, we recommend the use of strategies to retain voting and operational control in the hands of the owner, while shifting operational business risk (and potential upside) from the owner’s shoulders to that of the incoming owners. This allows owners to stay in control of their companies until they are assured of a successful transition and they achieve their planned personal financial security. We would be glad to talk to you about some of the ways in which we help clients accomplish this.

Element 9: Written Road Map With Deadlines

To succeed, we believe you should commit your transfer plan to a written document and communicate it clearly (and regularly) to the eventual owners. If the plan is not in writing, it simply is not credible, and neither you nor your employees will take it seriously. More importantly, the written plan is the playbook for your exit that you and they will use to coordinate your actions with those of your advisors (thus reducing delay and cost). The plan should include a timeline and provide accountability—who will do what, when—for all participants, including the owner. Without incremental, staged checkpoints, we find that transitions to insiders often falter. You’re not likely to finish a marathon if you don’t have mile-by-mile goals to meet.

Element 10: Education (Yours)

Owners need to understand the ins and outs of insider transfers because, unlike sales to third parties, they will control their businesses and the exit process until they have decided that it is succeeding. That education has already started as you read this newsletter.

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