STUART ADAMS
LAW OFFICE
A PROFESSIONAL SERVICE CORPORATION

PROTECTING YOUR BUSINESS AND YOUR ESTATE WITH A LIMITED LIABILITY COMPANY

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Have you considered using a limited liability company to protect your business assets and to reduce the amount of taxes your estate might have to pay upon your death? Much has been written about this device, which has only been available in this area for a few years, but a surprisingly small number of professionals seem to be taking advantage of this potentially valuable business and estate planning tool.

Most of us, hopefully, love our business or profession. Aside from the simple joy of coming to work every day, however, most of us would also like to be able to retain more of what we labor to earn. Years of hard work and the financial independence which should result from an accomplished career can be wiped out in a second of alleged negligence or through a bad business deal.

Our society seems to grow ever more litigious, and often the "deep pockets" of successful businesses are the targets. As if that were not enough, failure to attend to a realistic and up to date estate plan can result in unnecessary tax consequences, which can substantially reduce what you had intended to leave to your heirs.

Many professionals, such as those in the various medical professions and, strangely enough, the start-up computer consultants, seem, to have gravitated in the sometimes unfortunate direction of formalizing their business structure as a partnership arrangement, rather than using one of the more effective devices available, such as a corporation or limited liability company.

The use of the limited liability company may be particularly beneficial for professionals, such as physicians, dentists, accountants, engineers, and those in consulting practices. It is also a valuable tool in almost any other business where there is a high risk, such as construction, transportation, hazardous materials, etc.

The choice of business entity deserves a great deal of attention, both when the business is started and as it progresses and changes over the years. What may have been appropriate for a start-up may now be less than beneficial for a business where the owner is approaching retirement of sell off stage. A business which has grown from a couple of partners with few assets, may now be larger, more complex and "ripe" with assets subject to payment of damages in litigation.

REASONS TO CHOOSE AN LLC

There are three main reasons to pick a limited liability company as the legal form for your business entity:

- ❏ **Statutorily limited liability for tort and contract damages, unlike proprietorships and partnerships, where there is unlimited personal liability; and**
- ❏ **Taxation at partnership rates rather than at corporate rates, which can result in substantially reduced taxes; and**
- ❏ **Extreme flexibility, without most of the limitations found in "S" corporations and limited partnerships, resulting in the ability to tailor the control and equity in creative ways.**
- ❏ **Combines some of the most advantageous features of partnerships and corporations without many of the disadvantages found in either form.**

REASONS NOT TO CHOOSE AN LLC

The LLC is certainly not for everyone. There are a number of factors which might disqualify an LLC from consideration:

- ❏ **Most states allow an LLC to be formed with only one equity member. There must be two "members" for an LLC to be formed and have partnership tax rates. If you don't have a "partner" or co-member, such as a spouse, to form the entity, you may not be able to take advantage of this device. You should review this issue carefully with your CPA or tax advisor. You may also want to review I.R.S. Publications 3402 (Tax Issues for Limited Liability Companies) and 8832 (Entity Classification Election).**
- ❏ **The LLC is a relatively new entity in the US and the recognition of its limitation on liability and tax treatment may differ at least slightly in different states or countries.**
- ❏ **Death, disability or other specified factors can reduce the number of members of a small LLC below two, thus causing an untimely demise for your business entity.**
- ❏ **Accidental or unknowing violation of the minimal requirements of an LLC can result in reversal of the liability and tax treatment of the entity and its members.**

USE OF THE LLC AS AN ESTATE PLANNING TOOL

The LLC can be a wonderful estate planning tool, replacing the family limited partnership and the living trust, as well as many other devices. Once again, partnerships have no insulation from liability. To "get around" this, many planners set up a family limited partnership as a two tiered creature composed of a corporate general partner and a limited partnership. The flexibility of an LLC allows this to be done in one step rather than two, thus reducing the creation and maintenance costs, as well as the complexity, of the family limited partnership structure.

We are taught in school that the whole is equal to the sum of its parts. With the LLC, you can rewrite the math of your estate through the discounts the I R S has allowed in valuation challenges established over time. Several "discounts" are available to deflate the size of your taxable estate. Some of these include:

Lynnhurst Office Condominiums, Suite 1
8009 New LaGrange Road
Louisville, Kentucky 40222-4791
PHONE (502) 587-7750 \ FAX (502) 585-7177
E-mail: biz-law@juristechnology.com Web Site: http:juristechnology.com

- **Discount for a minority interest in the LLC, which results in an inability to control the entity; and**
- **Discount for lack of liquidity if the membership interest in the LLC cannot easily be converted to cash because the interest is subject to a transfer restriction, similar to a buy-sell agreement; and**
- **Discount for lack of marketability because the ability to sell the interest in the LLC is reduced by the closely held nature of the entity and the decreased likelihood of control or modification against the family interest.**
- **"Tacking" together of two or more of the above discounts to reduce the taxable valuation of an interest in the LLC from 100% of its pro rata value down to something approaching 50% of such value in some cases.**

Methods used to realize such discounts include setting up the LLC appropriately so that the senior members of the LLC retain control of the entity but breaking off minority interests and "gifting" them over time at greatly reduced rates to children, who will have neither control nor a majority interest until late in the plan. This can be an effective way to gift more than the $10,000 a year amount to a child by packing the LLC interest into shrunken bites. This can also be used to break up the estate to avoid the $600,000 Federal estate tax threshold, to speed up the transfer of the estate to the children, or to spread out the estate to children and grandchildren at an accelerated rate, while retaining control of the business or the family property.

All of these uses of a limited liability company deserve substantial consideration and expert guidance. The advantages and disadvantages of an LLC for a business or estate plan should be compared with those of other devices. The LLC, however, was designed to facilitate either conversion from another type of entity, such as a partnership, or merger with other forms.

Given the extreme flexibility of the LLC entity, its inclusion of some of the best features of partnership tax rates and corporate type insulation from liability, plus its usefulness in estate planning, it seems prudent to look into its potential value to your business and your estate plan.

A more recent short article on <u>Business Start-up Tax Issues</u> can be found by clicking on the hyperlink in this sentence.

COMPLIMENTS OF STUART ADAMS LAW OFFICE, P.S.C.
Lynnhurst Office Condominiums, Suite 1
8009 New LaGrange Road
Louisville, Kentucky 40222-4791
PHONE (502) 587-7750 \ FAX (502) 585-7177
E-mail: biz-law@juristechnology.com Web Site: http:juristechnology.com