

The Family LLC: A Powerful Estate Planning Tool

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Every family is unique, but some have more complex needs than others. High-net worth families whose wealth is primarily in the form of a family business or real estate usually have a bundle of concerns that might include the estate tax, potential tort liability, and planning for the orderly transfer of wealth and decision-making authority to the next generation.

At our firm, we often use an estate planning strategy for such families that addresses most of these issues at once, through the combination of a Revocable Living Trust (“RLT”) with a family limited liability company (“FLLC”).

A revocable living trust is a familiar estate planning tool for families along the entire wealth spectrum. Typically, a married couple would use the RLT to avoid probate, take advantage of each spouse’s federal estate tax exemption of \$2 million, and provide for orderly administration of assets in the event of incapacity. In this setting, the couple would transfer most of their assets into their trust and continue to manage them, as trustees, exactly as they did before. This generally avoids probate, but does not protect a family from creditors, or estate taxes on more than \$4 million in combined assets for a married couple. Families that have substantial wealth in the form of a business, real estate, or a stock portfolio can usually transfer enormous additional economic value from their taxable estates, without compromising their control over their assets, by integrating an FLLC into their estate plan.

Here’s how it works. First, the couple – let’s call them Mom and Dad – would create a new FLLC by having their trust file a simple form with the state where they live. The administrative tasks in setting up and running an FLLC are surprisingly manageable (especially in comparison to a corporation). Next, Mom and Dad, as trustees of their trust, would transfer their property from the trust into the FLLC, which is a distinct entity with its own taxpayer identification number. The trust would end up as the sole owner of all of the FLLC’s equity, which is referred to as “membership interests.”

Mom and Dad would continue to have complete ownership and control of their assets, through their status as the sole trustees of the trust that is the owner of the FLLC -- except that now the assets are owned by a separate company that provides statutory liability protection for its owners.

This liability protection is an important benefit of an FLLC. For example, imagine that Mom and Dad own a plot of land as community property that has a commercial vineyard. A visitor (or even a trespasser) who injured himself on that land could seek damages out of all of the assets of Mom and Dad. If Mom and Dad instead transfer the land to an FLLC, the injured person’s recovery for damages, in most cases, would be limited to the FLLC’s property – and would not extend to unrelated property owned by Mom and Dad or their trust.

Here's an example. Mom and Dad's trust transfers the family business into a newly formed "Mom & Dad LLC." The FLLC's operating agreement divides ownership of the company into 100 membership units. Ten of the units are titled "Class A," having ten percent of the economic value and all of the voting and management power. The other ninety membership units are designated "Class B," with no rights to vote or influence management, but with the right to receive 90% of the income of the FLLC. Mom and Dad initially own all of the units of both classes through their trust, and they name themselves as the sole managers of the FLLC. The result is that Mom and Dad still have full ownership and full managerial control of the underlying business.

Since the business is now owned by the FLLC, any creditor claims, including tort liabilities, that arise from those assets will be limited to the value of the FLLC – and creditors generally cannot reach beyond the FLLC to Mom and Dad's other assets to satisfy any excess liabilities.

At this point, Mom and Dad can establish a program of annual gifts of Class B membership units to their children or grandchildren, in amounts equal to or less than the amount of the annual gift tax exclusion amount (which is \$12,000 per individual in 2008). As a married couple, Mom and Dad can combine their gifts and transfer up to \$24,000 to each and every one of their beneficiaries without any obligation to pay a federal gift tax on the gift -- or even to file a gift tax return with the IRS. All of these gifts (and any future increases in their value) are forever removed from Mom and Dad's taxable estate, and over time these gifts can avoid huge estate tax bills that might otherwise have been levied on Mom and Dad's assets after they died.

But aren't Mom and Dad also slowly giving away their right to control the company in the way they always have done in the past? Absolutely not – because they keep all of the Class A membership units, which are the only ones with the right to vote and influence management. They continue to act as the sole managers of the family business by virtue of their roles as Managing Members of their FLLC.

The economic leverage of an annual FLLC gifting strategy can be accelerated dramatically with a tax strategy called valuation discounting. Since Mom and Dad have divided their FLLC into small pieces, and given them away to several beneficiaries who have no right to control or even influence the management of the FLLC's assets, the tax law permits the value of the membership interests to be discounted for the purpose of calculating the value of the gifts.

In our example, the beneficiary of two Class B membership units in the Mom & Dad LLC would actually own less than 2% of the value of the family business. Why? First, because he has no right to influence the management of the FLLC. He cannot compel the company to distribute any property or income to him, or to manage the business in a different way. Only Mom and Dad, as the Class A members, have the power over those decisions. He also has no ability to go out on the open market and find a buyer willing to pay "full" value for a small "Class B Membership Interest" in something called "Mom & Dad LLC." Indeed, the FLLC's operating agreement might explicitly restrict him from

selling to anyone outside the family. This lack of liquidity also makes the gift of the Class B membership interests to him discountable.

These valuation discounts can apply tremendous leverage to Mom & Dad's gifts. If the appropriate discount is 33% (a typical discount for a family business), Mom and Dad could actually give away Class B membership units with a "value" of \$36,000, and discount them to \$24,000, which would remain within the annual gift tax exemption.

Given Mom & Dad's ability to make these sorts of gifts to any number of beneficiaries, every year, for a period of years, it's easy to see how much economic value they can remove from their taxable estates and transfer to the next generation, completely tax free. If the gifted membership assets increase in value over time (because the family business continues to grow), the amount of the appreciation is also completely outside of Mom and Dad's estate.

Given that the federal estate tax rate is currently 46% (and scheduled to increase to 55% in the year 2011 unless current law is changed), an FLLC strategy could be expected to reap a tax saving of about half of the value of each dollar transferred during Mom and Dad's lifetimes. In addition, it leaves Mom and Dad completely in control over when and whether they decide to step away from management control over the FLLC's property.

We should note that in some cases the most valuable benefit of an FLLC strategy has nothing at all to do with money. Not all families get along. If Mom and Dad preside over a quarrelsome brood, they may be reluctant to turn family members into business partners. But by transferring to the family only Class B membership interests (which represent only the right to income), they can make gifts to any family members they wish without requiring them to cooperate and made decisions together. In the event that one or more family members emerge as the best candidates to replace Mom and Dad as managers, the voting Class A membership interests and the role of Managing Members could be concentrated in their hands. Family harmony is a non-economic benefit to be sure, but for some families it is an elusive goal that an FLLC can help to accomplish.