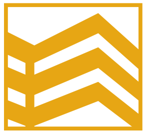
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Family Owned LLC's

One of the more common tools utilized by asset protection lawyers is the Limited Liability Company ("LLC"). As suggested by its name, this entity offers liability protection to its Members, including superior insulation from a piercing of the corporate veil than afforded by a corporation. When those involved in the asset protection plan are members of a family, a more particular LLC can be utilized, the Family Owned LLC ("FLLC"). The FLLC is not only a means to protect family assets, but can also facilitate estate-planning objectives.

Once the Members and Managers of the newly created FLLC are established, the entity is typically funded using of an asset transfer. An FLLC is owned by its "Members," while management of the organization is vested in one or more "Managers," who may also be Members.[1] Those who are only Members, typically children and grandchildren, have no right to participate in the management of the entity, may not withdraw unilaterally and receive cash for their membership interest, and are subject to restrictions on the transfer of their membership interest. The Managers, generally parents and/or grandparents, control the business decisions, and operate the LLC without interference from the other Members. The entity is viable even if a Manager is not a family member, therefore no change in operation or treatment occurs based on the participation of an unrelated party in this manner, so long as membership status is restricted to family members.

Based on recent case law, there are some restrictions on which assets can be transferred into the FLLC. Generally, no personal assets should be contributed to the FLLC, which in particular applies to a personal residence. It is important to observe the formalities of the FLLC as a business entity, something that is undermined by a situation where a grantor contributes substantially all of his assets to the entity, and then treats the FLLC like a personal bank account in order to sufficiently support him. Assets held by an FLLC are best limited to investment and business related assets, to ensure the legitimacy of the entity.

Estate Planning Benefits

The Managers of an FLLC can hold a small amount of the equity interest, yet retain complete managerial authority over the assets, even where the children/Members hold the majority of the equity interest. In an effort to maximize estate-planning efforts, a better result is achieved where the donor of the assets retains the Manager and non-Manager interests initially, but then gifts the non-Manager interest to children and grandchildren in increments that do not exceed the annual exclusion amount.2 Therefore, later generations slowly gain a greater interest in assets still controlled by the Manager of the FLLC, tax free. An added benefit from such a plan is that the gifted interests can be "discounted" due to lack of control or marketability, thus the actual value of what is gifted may well exceed the annual exclusion amount without triggering gift tax consequences.

Discounting an interest means valuing the interest based upon the monetary face value as well as any limitations on that interest that may make it worth less in the hands of a disinterested buyer. For instance, restrictions on the right to sell an interest in an FLLC make that interest worth less than its face value. This is potentially a HUGE estate tax savings feature. By gifting interests in the FLLC that have a face value of more than $11,000, but which are discounted in value to be gifts of an interest worth $11,000 or less, it is possible to shift more value each year under the annual gift exclusion then would be possible outside of the FLLC context. The one warning bell that goes off when using discounts is that the IRS looks very closely at them during an audit; therefore it is important to substantiate any discount taken, and ensure that the amount is reasonable.

Case Study:

Dean Smith is a retired doctor, holding approximately one million dollars in mutual funds among his assets. Dean decides to form an FLLC, which is funded by a transfer of the mutual funds. Dean is made the sole Manager, owning 92.5% of the membership equity interest, and each of his five grandchildren is gifted 1.5% interests. Although each 1.5% interest is worth $15,000 on paper, these interests are discounted by 26.66% due to lack of marketability and control. Therefore each transferred interest now falls under the $11,000 tax-free gift limit. Dean can make similar gifts of $15,000 worth of FLLC interests each year to each of his grandchildren completely tax free (assuming the discounts continue to apply). As the grandchildren accrue larger interests in the FLLC, Dean retains complete control of the mutual funds as the sole Manager, thus he retains the right to distribute income or sell and reinvest as he chooses.

Each year $15,000 of value is passing to each grandchild tax-free under the annual gift exclusion due to a discounting of the value to $11,000. An extra $4,000 per grandchild (or $20,000), per year, is passing out of Dean's estate due to this discount. After just 5 years Dean will have shifted $100,000 more out of his estate tax free than he could have using straight gifts outside of an FLLC format. That amount can expand a great deal based on larger discounts, more Members receiving gifts, or more years over which these gifts are made.

One drawback to this approach results from the funding of the FLLC with highly appreciated property. When an interest in property is gifted the basis in that property is carried over to the recipient of the gift. In the case of highly appreciated assets in the FLLC, the recipients of the gifted membership interests are receiving the property tax-free; however the difference in the carry over basis from the fair market value of that property is quite large, and will result in high capital gains taxes when sold.

Asset Protection

As was briefly discussed above, the FLLC serves a dual purpose, as both an estate planning vehicle and an asset protection tool. To preserve ownership of the FLLC within the family, sale or transfer of interests in the FLLC is often restricted by means of the Operating Agreement. Such provisions, in conjunction with the limited liability granted by state law, provide significant creditor protection.

The Operating Agreement lays out the rules under which the FLLC operates. It dictates how and to whom an interest in the FLLC can be transferred, if it can at all.3 It also establishes the powers held by the Manager(s) regarding what types of distributions can be made, as well as whether they are purely in the Managers discretion or not. Operating Agreements include a multitude of different options, many of which can significantly impact whether or not the entity fulfills the purpose for which it was created. When forming an FLLC it is a good idea to consult a lawyer who can guide you through the complex drafting process and ensure that the Operating Agreement incorporates all the necessary provisions.

Unlike a corporation, in which a creditor can seize a debtor's stock, a creditor generally cannot seize an ownership interest in an FLLC. Creditors holding a judgment against a Member of an FLLC, and not against the FLLC itself, are limited to a "charging order" against that Member's interest in the FLLC. A charging order stipulates that any "capital distributions" of property or funds from the FLLC to the debtor are instead payable to the creditor to the extent of the unsatisfied judgment.

What makes this a successful asset protection device is that the creditor can only collect on the judgment against the FLLC Member when a "capital distribution" is made to that individual. Distributions are only made at the discretion of the Manager; therefore the creditor has little hope of ever collecting on the judgment without agreeing to a settlement. However, the term "capital distribution" does not encompass expense or salary payments. Therefore, a Manager can cease capital distributions in order to avoid collection by a Member's creditor, but can still make payments in the form of salary, for example, which are beyond the creditor's reach (assuming the Member does something to warrant the salary payment). The creditor cannot force the sale of FLLC assets or a Member's interest, nor can it vote on behalf of the debtor/Member. The charging order is a creditor's sole recourse against an FLLC, hence the Manager(s) of the FLLC dictate when (and if) the creditor gets paid.

The only way that the assets of the FLLC are put at risk is if the FLLC itself is liable to a creditor. Unlike an operational LLC, however, the FLLC is never used as a true business entity, and therefore should not be engaging in any activity that could jeopardize its assets from a liability standpoint.

Case Study:

Dean's grandson Sam is not the most responsible of his grandchildren. Sam was recently in a car accident, and was at fault, thus bearing the burden of paying the $20,000 judgment. [Coming as no surprise to anyone in his family, Sam was driving without insurance, and therefore the judgment is against him personally.] Of course, Sam has no money, and so his creditor begins searching for assets, only to discover his membership interest in the FLLC. Sam's membership interest has increased to 4.5%, and he currently receives distributions on a quarterly basis of $5,000. Excited to see a chance to pay off a debt that looked like a write-off initially, the creditor tries to seize Sam's ownership interest, but cannot under statutory law. The creditor therefore obtains a charging order against Sam's interest, thus claiming the distributions to Sam to the extent of the $20,000 judgment. At the beginning of the next quarter the creditor is shocked when it does not receive a $5,000 distribution, and quickly contacts Dean. Dean explains that, under the provisions of the Operating Agreement, the Manager controls all distributions and since they are wholly discretionary he has decided not to make any this quarter, and indicates that he may not make any for some time to come. Dismayed by this, the creditor rushes off to court, only to be told that the distributions cannot be compelled. The creditor is suddenly ready to talk to Sam about a settlement of the judgment at a discounted amount.

By setting up an FLLC before any problems exist, it is possible to protect valuable assets and retirement funds from potential disaster. Where appropriate, such a tool can also be used as a means of transferring assets to children and grandchildren tax free, and without making use of the Unified Credit. Clearly the Family Owned LLC is a versatile tool that should be considered when discussing asset protection or estate planning with your attorney.

[1] A Manager is not required to hold an ownership interest as a Member. 2 The annual exclusion amount is the amount of money/property that a donor can gift to a donee without triggering the gift tax (or use a portion of the donor's Unified Credit). In 2004, the annual exclusion amount is $11,000 per donee. 3 Generally, if a transfer of an interest is allowed, the Members by a majority, 75%, unanimous, etc., vote must authorize it.

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