

USING LIMITED LIABILITY COMPANIES IN ESTATE PLANNING

1. **What is a Limited Liability Company?** A limited liability company (LLC) is a legal entity that became available under Oregon law in 1993. An LLC is an entity that provides its owners with beneficial tax aspects of a partnership, but which limits the liability of its owners much like a corporation limits its shareholders' liability.

For tax purposes, an LLC is a "pass-through" entity, meaning its income, gain, and loss is not taxed at the entity level. Instead, all items of income, gain, and loss pass directly through to the owners of the LLC, rather than being taxed at both the entity and owner levels.

"Limited liability" means that an LLC owner is liable only for the obligations of the business only to the extent of his or her investment in the LLC. Unless the LLC owner commits fraud or personally assumes a liability (like a bank loan), creditors and those bringing lawsuits against an LLC may recover only the value of the business assets, and not the owners' personal assets.

2. **Who are the Owners of an LLC?** Owners of an LLC are called "members." Each member's ownership interest is expressed in terms of the number of "units" owned by that member. A member's ownership interest is made up of "economic rights" and "management rights." "Economic rights" are the rights to receive income from the LLC or to be allocated gain or loss for tax purposes. "Management rights" include the right to control and manage the LLC.

3. **How Can an LLC Further a Member's Estate Planning Objectives?** The Internal Revenue Code imposes a tax on all transfers an individual makes during life (gift tax) and on the value of all property owned at death (estate tax). The estate tax and gift tax are imposed at a unified rate, beginning at 37 percent and increasing to 47 percent. There are exceptions for gifts of up to \$11,000 per gift recipient and for the first \$1,500,000 in property given away by an individual either during life or at death. There are also unlimited deductions for transfers to a spouse or to a charity. Careful planning allows LLC members to take maximum advantage of the exceptions and deductions available in making gifts and bequests.

Family-owned LLCs allow individuals to transfer economic wealth to their children (or others) while retaining significant control over property and by further providing "valuation discounts," which speed the rate at which wealth is transferred out of an estate, which, in turn, reduces estate taxes (as discussed below). To begin this process, you simply form an LLC and transfer selected property to it. By making annual gifts of ownership interest in the LLC, you can maintain control over property while taking advantage of the annual gift tax exclusion, thus decreasing the ultimate estate tax burden.

4. Procedure for Forming an LLC. Forming an LLC is a relatively easy process. To do so, you must first file a one-page document with the Oregon State Corporation Division called “Articles of Organization.” The document that governs the relationship between the members of an LLC is called an “Operating Agreement.” That document specifies who has the right to manage the LLC and who is entitled to the economic benefits received from the LLC. Finally, the selected property discussed above must be conveyed to the LLC. Beyond this, any gifts of ownership interest in the LLC should be documented and included with the records for the LLC.

5. Valuing LLC Interests. The value to be placed on an ownership interest of an LLC is influenced by many factors and can take many different forms. For example, some businesses are properly valued by calculating the total value of the underlying tangible assets, while others (such as businesses) are valued to include the goodwill associated with the business. Whatever the method of valuation is used, the value of the LLC may exceed the aggregate values of all of the separate ownership interests in that LLC’s business assets. Simply stated, the whole may be greater than the sum of its parts.

The Internal Revenue Service recognizes that the fair market value of a partial interest in an LLC may be less than that interest’s proportionate share of the ownership in the LLC—especially where the interest cannot easily be sold on the open market or where some members do not have control of the LLC’s assets. Together, these amount to a “valuation discount.” Another issue is whether the interest was obtained as the result of a lifetime gift or a bequest at death. In valuing ownership interests held by a deceased person, the valuation inquiry is focused on what the deceased person owned immediately before his or her death. However, in valuing gifts, it is not what the giver gave up that is valued, but rather, what the recipient received.

Therefore, an \$11,000 gift of a minority ownership interest in an LLC, properly discounted, may equal as much as \$15,000 or \$20,000 of the value of the underlying assets. Through annual gifts of ownership interests in the LLC, an LLC member can reduce his or her ultimate estate tax significantly.

6. Summary. By transferring property to an LLC and making annual gifts of ownership interests in the LLC to children, grandchildren or others, one can serve many estate planning objectives: keeping valuable property in the family, rapidly reducing estate taxes, and reserving significant control over one’s assets. In addition, many find that such a process actually serves to better prepare children for the succession of ownership interests in property by involving them in the management process from an earlier point in time.

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