



FAMILY LIMITED LIABILITY COMPANY

INTRODUCTION

A limited liability company is a business entity that insulates its owners from the liabilities of the entity like a corporation but is taxed for income tax purposes like a partnership. Limited liability companies are now recognized in all 50 states.

DESCRIPTION

A family limited company (“FLLC”) is a limited liability company formed principally among family members under Michigan’s or another state’s limited liability company act. An FLLC must have business purposes. An FLLC should only be formed in a state where the state law requirements for liquidation of the FLLC shall be as the owners (called members) specify in their operating agreement. The FLLC remains in existence until the earlier of the unanimous consent of all members, the expiration of a fixed term, or judicial dissolution.

Managers manage and control the FLLC’s business. The managers decide when to make distributions to members which, when made, must be proportionate to each member’s interest in the FLLC. The operating agreement may provide for one manager to control most FLLC activities including distributions to members.

The FLLC may own closely held businesses (other than corporations that have made an election to be taxed as “S” corporations), real estate, marketable securities, or almost any other investment asset. Homes, cottages, or other personal use assets are normally not suitable for an FLLC.

The family’s control of the FLLC assets will remain vested in the managers, but the members may gift during lifetime or transfer at death their interests in the FLLC. Under current law, the value of FLLC interests should be less than the value of the assets contributed to the FLLC. This discount can be significant.

ATTRACTIVE ATTRIBUTES

An FLLC is a very flexible planning tool. Its advantages may include some or all of the following:

- Preservation of a family's wealth in the family.
- FLLC meetings may promote or facilitate family communication regarding wealth, family investment philosophies, and other family values.
- Control of FLLC assets will be vested in the managers. The successor to a manager will also be determined by the operating agreement.
- The passing of membership interests by gifts or at death will not disturb the manager's control of the FLLC.
- Despite gifts, the family's wealth remains consolidated in the FLLC for management and investment purposes (e.g., investment advisers may be employed to manage all family wealth).
- Families with diversified investment portfolios are able to gift membership interests to younger generation family members without breaking up the diversified portfolio.
- The FLLC may minimize or eliminate the corrupting influence wealth can have upon younger generation family members during their formative years.
- Spouses may use the membership interests to "split estates" to avoid the wasting of generation-skipping tax exemption.¹
- The FLLC is much more flexible than irrevocable trusts when dealing with family wealth.
- When compared to trusts, FLLC activities are judged by the business purpose test, instead of the more stringent prudent person rule. FLLC assets may be invested using modern portfolio theories.
- The FLLC provides some asset protection against failed marriages of family members.
- The FLLC should substantially reduce the estate or gift tax burden that is imposed on wealth that is transferred to family members because the FLLC should be valued as a going concern, rather than at its liquidation value.

¹ The GST exemption is \$5,430,000 in 2015 and indexed for inflation thereafter.

- The FLLC protects member assets from the creditors of members. A creditor of a member may only obtain a charging order against the member's interest in the FLLC and not its underlying assets.
- Members are insulated from liability for the FLLC's activities.
- The FLLC can eliminate the need for probate of real property located outside of a member's domiciliary jurisdiction.
- The formation of the FLLC and capital contributions to it will normally be income tax free.²
- The FLLC may distribute cash or other assets proportionately to its members without triggering gain or loss.³
- The Operating agreement may require that FLLC disputes are settled confidentially by arbitration rather than litigation. To discourage frivolous disputes, the agreement may require the losing party to pay both sides' legal expenses.

FEDERAL TAX ATTRIBUTES

The FLLC will be taxed as a partnership. The FLLC is not subject to income tax. Each member reports his or her proportionate share of income or loss on his or her tax return each year regardless of whether a distribution is made to the member. Likewise, cash distributions to the members will not create taxable income because the members are taxed directly on FLLC income.

If the FLLC pays a wage or salary to anyone, it must report and pay all normal employment-related taxes.

The FLLC must annually file partnership tax returns.

STATE TAX IMPLICATIONS

An FLLC that is situated in Michigan will be required to file state income tax returns.

² Careful planning is required when a diversified investment portfolio or encumbered assets are contributed to the FLLC.

³ Careful planning is required if an encumbered or low basis asset is distributed to members.

Transfers of Michigan real property to the FLLC may permit the local tax assessor to adjust in the year of the transfer the property's assessed value to one-half of fair market value. When property is transferred to the FLLC, the assessor may not be limited by Michigan's new 5% cap on annual assessment increases.

Michigan real estate that is contributed to the FLLC could be subject to state and county real estate transfer taxes, which total .86% of the property value. The application of exemptions from these taxes for a conveyance of real estate to an FLLC is presently unclear. The fees or taxes for recording deeds for real estate in other states varies.

The FLLC conducting business or owning property in other states may be subject to taxation in that state.

IS THE FLLC "RISK FREE"?

The FLLC valuation discounts arise out of valuation principles. When an asset is given or owned at death, its fair market value must be determined. Fair market value is the price a willing buyer would pay a willing seller when both are reasonably aware of relevant facts. In early 1993, the Internal Revenue Service abandoned its long-held position that family relationships must be considered when determining fair market value. Since that abandonment, FLLC interests should be valued at the price strangers would pay for the interest.

It is this price which produces the substantial discounts. Because liquidation of the FLLC is remote, a "stranger" would value an FLLC interest as an interest in a going concern. However, the value of an FLLC interest that appears on a gift tax or estate tax return may be challenged by Internal Revenue Service auditors.

Planning techniques may help blunt a gift tax valuation challenge. A gift of FLLC interests to a Grantor Retained Annuity Trust ("GRAT") greatly reduces current gift tax exposure because of the nature of a GRAT and the GRAT must contain a valuation adjustment clause. A GRAT shifts to children, almost tax free, growth on GRAT assets above a certain rate. Another technique to reduce gift tax exposure involves a formula gift. The formula gift defines the amount of the gift to family members as a fixed dollar amount with any value in excess of that amount to charity or a spouse. Because any value above a family member's defined amount (e.g., a gift of \$20,000 to a child) passes to charity or a spouse, any valuation increase on a gift tax audit should produce a charitable or marital gift tax deduction instead of the payment of gift tax. Any charitable benefit should also qualify as an income tax deduction, subject to normal rules regarding deductibility for income tax purposes.

Careful planning, a properly drafted operating agreement, and a competent appraisal whenever significant FLLC interests are subject to gift or estate taxation mitigates, but cannot eliminate, the risk of an Internal Revenue Service valuation challenge.

UNDER WHAT STATE LAW SHOULD THE FLLC BE CREATED?

We recommend that a Michigan limited liability company be used. A Michigan FLLC is formed by filing articles of organization with the State of Michigan (\$50 filing fee and usually a \$12.50 expedited service fee) and thereafter files annual reports that list only the registered agent and registered office. The public filings with the State of Michigan do not disclose financial or other details about the FLLC.

WHAT COSTS ARE ASSOCIATED WITH THE FLLC?

In addition to the fees and expenses noted above, you will have legal fees for the planning, formation, and transfer of assets to the FLLC. After we understand your situation, we will be happy to give you an estimate of our fees.

The FLLC must file annual partnership tax returns. Your accountant should give you an estimate of their probable annual charges for the returns.

Depending upon the assets that are contributed to the entity, there may be recording or other fees arising from the transfer of assets to the FLLC.

An appraisal of the FLLC interest is strongly recommended if you give membership interests to your family members and seek to support valuation discounts. To properly appraise FLLC interests, it may also be necessary to separately appraise FLLC assets (e.g., real estate or closely held businesses). While an appraisal of an FLLC may cost several thousand dollars, it is essential to support the going concern, instead of liquidation, value of the interests. Your estate must also appraise the remaining interests that you own at your death.

CONCLUSION

An FLLC is a very attractive tool that may be used to serve many goals of families with wealth.

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