ADVANTAGEOUS USES OF LLCS

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A. Using an LLC to Hold Real Property

Before LLCs gained popularity in the 1990s, limited partnerships and partnerships were the entities of choice for real estate investment. Limited partners were protected from personal liability while also being able to take passed through tax losses (subject to IRS rules--you'll need an accountant or attorney to sort out the issues of at-risk limitations and so on) from the property. The biggest downfall with limited partnerships was that someone had to be the general partner and expose themselves to unlimited personal liability.

LLCs don't require a general partner. All LLC owners--called members--have complete limited liability protection. LLCs avoid the double taxation of corporations, and have complete limited liability for all members. For holding investment real estate, the LLC is the best of all worlds when it comes to business entities.

If real property is being transferred, a quit-claim deed transferring title to the LLC must be prepared and recorded. If investments are being transferred to a LLC, they should be put in the name of the LLC using its tax identification number. Any non-titled property can be assigned to a LLC by a simple assignment.

Liability

- An LLC's members cannot be held personally responsible for any debts incurred by the company or be personally named in any lawsuits filed against the company. These protections are useful in the ownership of property. If someone is injured on the property and files a lawsuit or if someone is found to be conducting illegal activities there, members of the LLC are protected from liability and their personal assets are not affected.

Profits

- An LLC does not file a corporate tax return; all profits and losses flow through to the members, and they record their shares on their personal income taxes. When the property sells, this offers tax advantages over other types of corporations that provide similar liability protection.

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For example, when property being held in a C-corp is sold, corporate taxes are taken out of the profits before being distributed as dividends to the owners, then taxes are assessed on the dividends on the owners' personal tax returns.

Transfer

- The transfer or conversion of property held in an LLC is easier than with other types of corporations. If property held in an LLC is traded in a "like-kind" exchange (in which similar properties are exchanged) or converted to personal use, there are no tax consequences. However, the IRS considers the trade or conversion of property held in a C-corp to be a sale, which does trigger tax consequences

Mechanics

Purchase outright or finance a piece of real estate. The property can be purchased before or after the LLC is formed. Purchasing real property after the LLC is formed can have the unintended consequence of subjecting the purchaser to the more stringent commercial lending standards. Commercial lenders have less flexibility in underwriting loans when compared to residential lenders.

To transfer interest in real property, you must ensure the title company will allow you to add the LLC to the title. Even after the transfer, you are personally responsible for any mortgage.

The transfer is not a taxable event. No gain or loss is recognized by the transfer. This is the primary advantage of using an LLC over the S Corporation for holding real property.

Once the property is transferred, any income or losses generated will be attributable to the LLC. The net income -- loss -- will be reflected on Schedule C of the Form 1040 return for single-member LLCs. Mutli-member LLCs -- other than husband and wife -- will file a 1065 partnership return and each member will recognize the net income -- loss -- from the Form K-1 on their Schedule E of the Form 1040.

The property held by the LLC should now have commercial property insurance. Check with your insurance agent because the original home owners' policy may not suffice.

Multiple Entities For Multiple Properties

Now that you're convinced you should use an LLC to hold your real estate, the next question is how many properties per LLC should you have. Should you create one LLC and hold all your property under it, or should you create a new LLC for each property?

There are several reasons why you should consider having multiple LLCs--one for each property.

First, having multiple entities prevents "spillover" liability from one property to another. Suppose you have two properties worth $500,000 and they're held in the same LLC. If a tenant is injured at property 1, and wins a $750,000 judgment, he will be able to put a lien on BOTH properties for the entire $750,000. Even though property 2 had nothing to do with the plaintiff's injury, the plaintiff would still be able to attack that property.

On the other hand, if each property had its own LLC, then your creditor could only put a lien on the property where she was injured (assuming that they cannot pierce the corporate veil).

Many banks and lenders require separate LLCs for each property. They want the property they're lending against to be "bankruptcy remote". What this means is that the lender doesn't want a problem at a separate property to jeopardize their security interest in the property that they're lending on. If they are lending money to you to buy the building on 123 Main Street, they only want exposure to risks from 123 Main Street, and not from a bunch of other properties that you own elsewhere. Therefore, lenders often insist on a new entity for the property they are lending on.

Multiple LLCs For A Single Property

You can also use multiple LLCs for a single property. In this case, you would have one LLC own title to the property, while a separate LLC managed the property--i.e. handled repairs, collected rent, paid taxes, etc. For example, if you owned the building at 123 Main Street, you could form an LLC called 123 Main Street Partners, LLC and a second entity to manage the property called Main Street Management, LLC.

You should discuss the use of multiple entities for real estate investment with your attorney or accountant. The use of multiple entities can have tax consequences that are favorable or unfavorable depending on the details of the arrangement--and only an attorney or accountant working with you can arrange the details properly.

Residential Real Estate

Also, when it comes to owning residential property in an LLC, you will frequently find that residential lenders will not lend to the LLC but will require the property to be in the individual owner's name. In some states, transferring title to and from one party to another can be quite expensive and time consuming.

In your case, you should determine what your objectives are in transferring the property to the LLC. Figure out what benefits you will get from owning the property in the LLC and then determine what your costs will be to have the property in the LLC. If your only issue is your personal liability due to an accident that could occur at the property, you might just want to get yourself a more comprehensive insurance policy that covers not only the property but also has an umbrella coverage that will cover that property and other properties you own. You might also consider increasing the limits of your coverage on your insurance policies.

When you review all of the benefits and costs, you can then make a better decision as to whether you can or want to transfer title from your name into the LLC.

Finally, in some states, when you purchase a property you obtain a title insurance policy that covers you for any loss or damage you may sustain in case the property turns out to not be yours but claimed by someone else. Among other title issues, the title insurance policy will give you some assurance that you own the property free and clear of other people's claims and rights. When you sell the property, that title insurance does not transfer to your buyer. Given your scenario, your transfer from your name to an LLC may be considered a sale and the LLC would not be protected under your title insurance policy.

If you, as a seller, transfer title in some states using a quitclaim deed, the buyer gets title to the property but does not get any rights to sue the seller in case there are any title defects. However, if you transfer title using a warranty deed, the buyer has the right to sue you for title defects. And, once you are sued, you can tender that defense to the title insurance company that insured you when you owned the property. It's a small distinction, but it gets around the issue of having to obtain a new title insurance policy when you transfer title from your name to the LLC.

Under newer title insurance policies, certain transfers will continue to be covered under the original title insurance policy. One of those transfers would be a transfer to a living trust or from one family member to another. However, generally, when you transfer the property to an LLC, the original title insurance policy may not cover the LLC unless you have the title insurance company issue an endorsement to the original policy or issue a new policy.

As for what you should do, you will need to decide that for yourself once you have gathered all the information. For some, the choice is easy and they go the route of creating an LLC because they plan to invest in many properties and create a little real estate empire. Others who will only own one or two properties often decide to hold title in their names and make sure they have great insurance.

B. How You Can Hold Tangible Personal Property or Intangible Assets

An LLC can hold investments such as stocks, bonds and mutual funds, and residential real estate such as a vacation home.

S Corporation stock; however, cannot be transferred to an LLC because of legal restrictions on the ownership of this type of stock. Also, it is not advisable to transfer units of stock in a family-owned business that is a C corporation. The retention of voting rights of that stock by a member can cause inclusion of the stock held in the LLC in the estate of the member at his/her death. Further, qualified plans cannot be transferred into an LLC.

Personal Property (i.e., Vacation Home)

Nevada, unlike almost all other states, allows limited liability companies (LLC's), to be established for non-business purposes. Specifically, a Nevada LLC can be used for any lawful purpose and can be used to provide asset protection and as a means for managing and controlling not only vacation home properties, but also many other forms of personal use property. For example, a Nevada LLC can be used by individuals and by families where the LLC's property is not used for business purposes (rental or other commercial purposes) but is used instead as a vacation home or for some other non-business use

Moreover, the extreme flexibility of the LLC form permits a family to use an LLC to hold a vacation home as a means for establishing a systematic method for managing and controlling vacation homes, restricting transferability of ownership interest, preventing and resolving disputes among family members and for providing estate planning and gifting options that would not otherwise be available to a vacation home that is held individually or by multiple family members in a tenancy in common or other ownership method.

Vacation homes may also take many forms. They may be a mountain escape in Lake Tahoe or a beach destination on the California Coast. They may also be a luxurious motorhome, a houseboat, or a yacht.

In most instances, the traditional forms of joint ownership among family members, namely tenancy in common and joint tenancy with the right of survivorship, do not work well with family vacation homes. The problem with those types of ownership is that the ownership interest often becomes fractionalized and difficult to pass down multiple generations of family members.

Using an LLC to own the vacation home solves many of these problems. For tax purposes, the expenses of ownership,--mortgage payments, property taxes and maintenance--can be

allocated among members in accordance with usage or some other purposes. To that extent, the costs can be also allocated for tax purposes on the basis of who paid the expenditure. Additionally, use of the LLC charge and owner protection means the vacation home can be asset protected against claims of creditors of any individual family members. That would not be the case with a tenancy in common in that a creditor could potentially force the partition of the property in order to pay for an outstanding liability of a family member.

In summary, there are five specific reasons why an LLC is preferable to other forms of ownership of a vacation home.

- An LLC can limit the owners' exposure to lawsuits by vacation home users and creditors (asset protection).
- An LLC can impose transfer restrictions and prevent owners from forcing the sale of an interest in the vacation home, thereby making it easier to keep the vacation home in the family.
- Because the LLC is an entity, it can hold operating funds and effectively report the sharing of income and the allocation of expenses among vacation homeowners in accordance with usage.
- An LLC has perpetual existence. The Operating Agreement for the LLC can establish rules for expense sharing, scheduling, dispute resolution and buy-sell provisions in the event that one of the owners wants to sell his interest.
- In Nevada, an LLC provides charging order protection (asset protection) for single member LLC's. Thus, in the event that one family member buys out all the other family members, he or she will still continue to realize the asset protection of keeping the vacation home in an LLC form.

Intangible Assets

An LLC is a hybrid. To a certain extent, it is an entity separate and distinct from its owners, the members. Were that not the case, an LLC would not afford its members with limited liability, defeating its purpose. Consistent with the underlying rationale for LLC's, California follows most other states in providing that a membership interest in an LLC is the member's personal property, and that the member owns no interest in the LLC's assets.

For other purposes, however, -- especially tax purposes -- an LLC is an aggregate of its members. We ignore the separate identity of the LLC and tax each member on the member's proportionate share of income, gains and losses arising from the LLC's assets, as if the members were tenants in common in the underlying assets.

For federal tax purposes, the regulations assert that federal law, not state law, will determine whether an entity is separate from its owners for federal tax purposes. However, the "check the box" regulations give the owners of an LLC a choice: they may elect that the LLC be ignored for tax purposes and taxed as a pass-through entity, or they may elect the LLC be subject to tax as a separate entity. If an LLC makes no election, it will be deemed to have elected to be taxed as a pass-through entity. An LLC that has only one member may also elect to be taxed as a separate entity, and if not it will be deemed to be a "disregarded" entity for federal income tax purposes.

Is a Membership Interest Tangible or Intangible Property?

If a membership interest in a California LLC is, by statute, personal property, does it follow that the membership interest is an intangible asset? For a U.S. citizen (or non-citizen domiciliary), the issue is of little transfer tax consequence, because a U.S. citizen is subject to gift taxes on the gifts of intangibles and is subject to estate taxes on intangibles owned at death. But the issue is of critical importance to an NRA. The Code is silent on the issue.

It is difficult to imagine anyone making a cogent argument to the effect that a membership interest in an LLC is a tangible asset. Most LLC's do not issue certificates to their members. A membership interest is nothing more than a contractual right to a proportional share of the LLC's income, gains, losses and distributions. The Supreme Court has so held in Blodgett v. Silverman. In Blodgett, the decedent, a Connecticut resident, owned a partnership interest in a New York limited partnership, which in turn owned real estate in New York. The Supreme Court noted that New York's limited partnership law -- similar to California's LLC statute -- makes partnership interests personal property, and that:

"...the interest of the decedent in the partnership...was simply a right to share in what would remain of the partnership assets after the liabilities were satisfied. It was merely an interest in the surplus, a chose in action. It is an intangible, and carries with it the right to an accounting."

Although Blodgett v. Silverman is somewhat long-in-the-tooth, it remains good law. We can be confident that LLC membership interests are intangible assets.

What is the Situs of a Membership Interest?

We have seen that a gift of an intangible asset by a Non-Resident Alien (“NRA”) is not subject to gift taxes, regardless of its situs. But many NRA's do not have the foresight to make gifts of intangible assets during lifetime. Since NRA's are subject to estate taxes only on their U.S.-situs assets, the situs of LLC interests may be of critical importance to those NRA's who failed to plan ahead.

The regulations provide that a partnership that is engaged in a trade or business within the U.S. is a "resident" partnership, and that a partnership not engaged in a U.S. trade or business is not a resident partnership. The same regulation makes it clear that whether a partnership is resident or non-resident is not determined by the residence of its members or the place in

which it was created or organized. Of course, this regulation provides no guidance as to the situs of a partnership interest.

Once again, the Supreme Court in Blodgett v. Silverman, supra, may provide the dispositive answer. In Blodgett, the decedent was a Connecticut resident who owned a partnership interest in a New York partnership that, in turn, owned New York real estate. As indicated above, New York followed the entity theory, treating limited partnership interests as personal property, and, per the Court's other holding, as intangible assets. The principal issue before the Court was whether Connecticut could constitutionally subject an interest in a New York partnership to Connecticut inheritance taxes. In holding that it could, the Court invoked the common law rule of mobilia sequunter personam (movables follow the person). However, in holding that Connecticut could apply its transfer tax to an intangible asset based solely upon the decedent's residence, the Court did not hold that New York State, the jurisdiction in which the partnership was incorporated and in which the real estate was located, could not have taxed the Connecticut decedent's partnership interests.

Due to the absence of any guidance in the Code as to the situs of partnership interests and the uncertain application of Blodgett, many estate planners have been reticent to advise NRA's to hold U.S. real estate in partnership or LLC form. That reticence may now be misplaced.

<u>The Importance of Pierre v. Commissioner</u>

In a recent case, Pierre v. Commissioner, the Tax Court may have finally put to rest any uncertainty as to whether a court -- for transfer tax purposes -- will look through the entity to the underlying assets to determine the situs of assets held by an LLC. Stated otherwise, at least for transfer tax purposes, the aggregate theory of partnerships appears to be finally dead.

Pierre involved a fairly typical estate tax freeze. Mrs. Pierre formed a New York LLC. Like California, New York provides that a membership interest is personal property and that a member has no direct interest in any LLC assets. Mrs. Pierre was the sole member of the LLC. Because she did not make an election, the LLC by default was treated as a disregarded entity for federal tax purposes. Contemporaneously with the creation of the LLC, Mrs. Pierre created two trusts, the "J Trust" and the "K Trust" for her son and grandchild. She then contributed $4.25 million to LLC, and shortly thereafter made gifts of 19% of her LLC membership interest to the two trusts, using her lifetime gift tax exemption to avoid the payment of gift taxes. For gift tax purposes, the membership interests were appraised and steep discounts were applied. She then sold the remaining 81% interests to the two trusts for a promissory note. The purchase price of the 81% interests was also based upon the discounted gift tax valuation.

In asserting a substantial gift tax deficiency, the IRS theory was simple and straightforward. The LLC was a disregarded entity for federal tax purposes, and disregarded means disregarded. The gift tax should have been based on the value of the underlying assets -- the cash -- and hence no discount was warranted.

One can almost sense the IRS' confidence as it girded for battle. After all, the check-the-box regulations make it clear that whether an entity is separate from its owners "is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." Moreover, the regulations provide that an unelecting single-member LLC must be treated as a disregarded entity. Mrs. Pierre, having decided to create a disregarded entity, should now be stuck with it.

A sharply-divided Tax Court disagreed. The majority held that the check-the-box regulations do not override the general rule that state law determines property rights, and New York has determined that a member of a New York LLC has no interest in the underlying assets of an LLC. Only after the rights of a member have been determined under state law does federal law determine how those property rights are taxed. In light of the fact that the check-the-box regulations (which are, after all, promulgated pursuant to a federal statute) appear to say just the opposite, the majority labored to draw a distinction between the classification of an entity, which is governed by the check-the-box regulations, and the valuation of assets, which remains governed by a state law's characterization of an asset.

Pierre v. Commissioner did not involve an NRA, but its applicability to the transfer tax liabilities of NRA's is obvious. If the IRS could not apply the aggregate theory of partnerships to impose a gift tax the underlying assets of a disregarded entity, it is not likely to successfully contend that the gift of an LLC interest by an NRA should be ignored and that the underlying U.S.-situs real estate should instead be included in an NRA's taxable estate.

A Planning Tip

All of the foregoing notwithstanding, there is a better way and a worse way for NRA's to avoid estate taxes. NRA's who plan ahead form LLC's and take title to U.S.-situs assets directly into the LLC. When the creation of the LLC and the acquisition of the assets is "old and cold," the NRA then gifts the LLC interests to the younger generation or whomever is the object of NRA's estate. Those who don't plan ahead are forced to create an LLC after the property has already been acquired by the NRA, who then transfers the property into the LLC, whose membership interests are then gifted to the beneficiaries. All of which invites the IRS to argue that a "step transaction" has occurred and that the transfer of the U.S.-situs property into the LLC in the first place was motivated purely for tax avoidance purposes. Bottom line: NRA's who don't plan and as a result pay estate taxes deserve what they get.

The Big Picture

Tax planning for NRA's would be easy if all we needed to concern ourselves with was estate taxes, especially if the real estate owned by the NRA is a non-income producing residence. But if an NRA owns an interest in income-producing U.S. real estate, the planning suddenly becomes substantially more complicated, dependent upon a myriad of tax and non-tax variables. For example:

Conclusion

If an NRA owns non-income producing U.S. real estate, all we need to concern ourselves with (at least from a tax standpoint) is estate taxes on the value of the residence when the NRA dies. The NRA can easily avoid this result by taking title to the real estate in a foreign or domestic LLC and making gifts of the LLC membership interests during his or her lifetime. But the planning is more complicated if the real estate produces income. There really is no optimal manner in which an NRA should hold income-producing U.S. real estate. All of the facts and circumstances, including whether the NRA intends to sells the U.S. real estate and the country of the NRA's residence, will determine the optimal structure.

C. As a Valuation "Freeze" Entity

Estate Freeze Technique

An *estate freeze* is a legal estate-planning technique used to lock in the current value (and tax liability) of a capital property for one person, while attributing the value of future growth of that capital property to another person. This provides taxation, estate planning and business advantages by ensuring current owners (e.g. parents) of an asset can continue to control that asset while allowing other persons (e.g. children) to benefit from (and be liable for the taxes payable on) the increase in value of the asset after the date of the estate freeze.

Practical uses of an estate freeze include transfer of control of a privately held business between generations, deferral of the taxes payable upon the disposition of the shares of that business, income-splitting between family members and protection of assets from creditors. Appreciating assets may be transferred from parents to their children on a tax-deferred basis, with the parents retaining control of the assets during their lifetime.

Transfer into an LLC

A transfer of property to an LLC is treated as a contribution of capital to the contributing member's capital account. A gift does not occur until a member transfers a portion of his or her units in the LLC to other members.

Today's combination of depressed values and low interest rates has created a situation ideal for estate planning. One way to take advantage of what could be a once-in-a-lifetime opportunity is to set up an estate freeze transaction; essentially a lifetime gift, the value of which is "frozen" at the time it is gifted for estate purposes.

The idea behind an estate freeze is to transfer value to the next generation at a low current value and to remove appreciation after the transfer date from the transferor's estate. In its simplest form, an estate freeze transaction consists of an outright lifetime gift that appreciates in value between the date of the gift and the date of the transferor's death. The gift is factored into the transferor's estate and gift-tax exemptions and exclusions, but the appreciation is not. Establishing the lifetime gift avoids the appreciation being subject to estate tax of potentially 45 cents on the dollar or more. Many variations on estate freeze transactions have been employed, including transferring assets to entities—such as family partnerships or limited liability companies— and utilizing these structures to facilitate the transferring of minority interests and nonmarketable units of value in order to take advantage of available valuation-discounting opportunities.

Aggressive valuation discounts have caught the attention of the IRS and Congress, and this area has seen a lot of regulatory, audit and legislative activity. However, freeze transactions remain available and are extremely effective at this time. In the following sections, we will explore various types of estate freeze transactions in use today, as well as their possible risks and benefits.

Grantor Retained Annuity Trusts

A twist on an outright gift is a gift in trust. These freeze transactions are established as split-interests where the donor retains an interest for a term of years and the remainder passes to the beneficiaries at a later date. The gift tax value of the remainder interest, the enjoyment of which is being delayed until the retained interest expires, can be discounted based on IRS valuation tables if properly designed. This type of transaction is most commonly done in the form of a grantor retained annuity trust, or GRAT.

A GRAT is a specialized trust with only one purpose: to transfer wealth, usually to children or to trusts for their benefit, in a way that is transfer-tax efficient. The valuation of the gift is based on the value of the asset transferred less the retained annuity interest, the value of which is determined based upon IRS interest-rate tables, which are adjusted monthly. A GRAT works best when interest rates and asset values are low.

The basic transaction involves the transfer by a grantor of an asset to a trust. The trust pays the grantor a fixed amount of the assets held by the trust each year. This is the annuity amount. At the end of the term that is chosen by the grantor at the time the GRAT is established, the property in the trust passes to the trust's beneficiaries. The grantor can select the term (currently it must be at least two years[1]) and must survive the term in order to keep the remaining trust assets out of his or her estate. Any income produced by the assets in the GRAT is the responsibility of the grantor. Although counterintuitive, this is an added benefit because the payment of income taxes by the grantor reduces his or her estate. The assets can be sold prior to the end of the term and the grantor is responsible for the capital gains tax. Effectively, the tax payment becomes an additional tax-free gift to the grantor's heirs.

Zeroed-Out GRATs

A variation of this estate planning technique is known as a zeroed-out GRAT, in which the grantor transfers property to the GRAT and a calculation is completed to determine the payment stream required to equal the fair market value of the assets transferred to the GRAT. The calculation is based on the IRS tables, which are keyed to the hurdle rate—or section 7520 rate—which the IRS adjusts on a monthly basis. If the assets in the trust grow at a greater rate than the 7520 rate, which was in effect at the time the GRAT is established, the excess passes transfer-tax free to the beneficiaries. Consequently, when interest rates are lower, more wealth can be transferred to the beneficiaries as assets appreciate in value. Note that the IRS regulations allow for a 20% increasing annuity payout as part of the calculation.

Let's use an example to illustrate the dramatic impact of lower interest rates. Assume that you have shares of stock in ABC corporation that have dropped in value over the past few months, but you still like the prospects for the stock. Also, assume you transfer $5,000,000 worth of shares to a 10-year zeroed-out GRAT when the 7520 rate is at 3.4%, as in May 2010. If the stock appreciates at 6% and produces income of 2% over the 10-year period, at the end of the 10-year term $2,710,916.62 passes gift-tax free to the beneficiaries. If the same transaction had been executed in December 2007 when the 7520 rate was higher, at 5.0%, a value in the amount of only $1,838,516.90 would have been transferred gift-tax free at the end of the term. Based on these assumptions, the lower rates create an additional gift-tax free transfer of

almost $900,000. Note that, as the grantor, you get your $5,000,000 back in the form of 10 years of payments that incorporate the IRS-mandated interest factor. The transferred assets are effectively frozen at today's value and the growth over the term of the GRAT passes outside your estate at no gift- or estate-tax cost.

Installment Sales

An installment sale is another variation of estate freeze. In the context of estate planning, an asset is sold to a trust or to a family member in exchange for a note. The note can vary by the type of note, the term and payment schedule of the note and the interest rate acceptable to avoid a gift element to the note. Typically, these rates are based on the applicable federal rates or AFRs that are adjusted monthly and are keyed to the term—short term, mid term or long term. If the asset appreciates at a higher rate, the excess value passes estate- and gift-tax free. Low interest rates and low values are prime drivers of the success of this technique. If structured as a sale to a trust, the transaction is generally known as a sale to an Intentionally Defective Grantor Trust (IDGT).

IDGTs as an Alternative to GRATs

An IDGT is commonly used as an alternative transaction to the GRAT. The IDGT transaction is also a freeze transaction that works in the current environment of depressed asset values and low interest rates, as the appreciation over and above the interest rate on the note can be passed on to children, grandchildren and their descendants free of estate tax and generation-skipping transfer tax. Similar to a GRAT, the grantor effectively owns the assets in the trust and is taxed on all income and capital gains generated by the assets in the trust.

An IDGT involves the creation of a grantor trust that is typically funded with at least 10% of the value of the asset to be sold to the trust in the transaction. In other words, in connection with a $5,000,000 transaction, the trust would be funded with at least $500,000. The trust would be irrevocable and the initial transfer would be treated as a gift that would use up to $500,000 of the grantor's lifetime exemption.

The grantor would then transfer the asset (e.g., stock in a business) to the trust in exchange for a note. The exchange by the grantor of the assets for the note is not treated as a sale for income-tax purposes and no gain or loss will be recognized as a result of the transaction. The note would be equal to the fair-market value of the asset, plus it would bear interest at the appropriate applicable federal rate consistent with the term. These rates are now extremely low; consequently, this is a great time for this transaction.

This transaction has several advantages over a GRAT. First of all, the rates are generally lower than the required rates for a GRAT. Second, the beneficiaries can pass to multiple generations without any generation-skipping tax consequences, if structured correctly. Third, annual valuations that may be required for a GRAT may not be needed if the note is structured as interest only with a balloon payment at the end of the term. On the other hand, this technique has not been entirely vetted by the IRS. Consequently, some estate planners feel that it is a bit more risky than a GRAT, which is sanctioned by the Internal Revenue Code. Also, a zeroed-out GRAT does not utilize any gift-tax exemption and an IDGT transaction requires an upfront gift to fund the trust.

Intra-Family Loans

A related alternative to an installment sale is an intra-family loan. Rather than a sale of the asset, the money is instead loaned to the family member with a payment schedule that is determined based on the terms of the loan and the IRS-published rates. A low-rate environment can provide opportunities for freezing values at low valuation and transferring appreciation above the loan rates to successive generations.

Currently, interest rates are not just low—they are extremely low. The following examples are based on the May 2010 short-term rate of 0.79% for three years or less and the mid-term rate of 2.87% for less than 10 years. If you loan $1,000,000 to a family member and take back a three-year note based on these rates and the assets experience an increase of 5%, $132,721 can pass gift-tax free to the family member. If you loan $1,000,000 to a family member and take back a nine-year note and the assets experience an increase of 8%, $640,614 can pass outside the transfer-tax system. These loans assume an interest-only payment in the initial years so that the assets may be invested longer and more may pass outside the transfer-tax system.

The notes should be in writing and the payment schedules should be followed. If portions of the payments are to be forgiven, the annual exclusion amounts (currently $13,000 per donee or $26,000 if the donors are married) can be utilized. An intra-family loan is a straightforward freeze transaction and, like the other techniques discussed, works well when asset values and interest rates are low.

In utilizing an intra-family sale, business owners have the opportunity to realign the capital structure of their businesses to facilitate an estate freeze of their ownership but not dilute control through the use of limited-liability-company entities or voting and nonvoting stock or partnerships. The freeze benefits of these transactions are similarly beneficial when valuations are depressed and rates of return are adjusted downward. The benefit of using this type of asset in connection with the other freeze techniques, in particular in connection with GRATs or installment sales, is to compound the benefit of lowering values through discounts to increase the appreciation potential of the transferred asset upon termination of the GRAT or installment term.

Conclusion

The recent turbulent times will be remembered for many things: subprime meltdowns, the banking crisis, TARP, unemployment, pirates, wealth evaporation, etc.; but perhaps the sleeping giant among all circumstances is the creation of wealth-transfer opportunities in a time of low values and low interest rates. Transactions that are ideal to be considered at this time are those that freeze values at the low current levels, transfer them at a later time to children and heirs at an appreciated value and are subject to an extremely low interest-rate toll charge, based on IRS interest rates in effect at the time of transfer. GRATs were introduced in October 1990, when the 7520 rate or hurdle rate was 10.6%. That rate in May 2010 is hovering between 3.2% and 3.4%. Based on these numbers, assets do not have to increase much from their current depressed values to create an opportunity to pass significant wealth in the form of appreciation.

Individuals (and their heirs) who act under these conditions may have the opportunity to save a significant amount on transfer taxes. Outright gifts, discounted transfers, GRATs, IDGTS and intra-family loans all can be entered into with a bias that favors the family—rather than the government.

D. Estate Planning Options

There are many benefits to implementing a LLC as part of an estate plan. The two primary benefits are to 1) “fractionalize” interests in property for the purpose of carrying out a gifting strategy and 2) to seek “discounts” on gifts made and on the transfer of a member’s remaining interest in the LLC at death. These benefits of an LLC also reduce death taxes.

Fractionalizing Property Interests

When property is transferred into an LLC, company units or interests are created and assigned a value. The units represent a fractional interest in all of the company assets, the same as stock in a corporation. This makes it possible and convenient to gift assets which are not easily divisible. The LLC creates a “currency” of company units that can be easily transferred on an annual basis.

Example: Joe and Shiela Smith want to give their children, Thomas and Sue, a portion of an apartment building that they own. The reason for the gifts is to reduce estate taxes at death. Joe and Shiela create a LLC with themselves and Thomas and Sue as members. Joe and Shiela transfer the building into the LLC by quit-claim deed. The fair market value of the apartment building is professionally appraised to be $500,000. The members agree that the LLC will have 500 units and that each unit is worth $1,000. Joe and Shiela can now give units of the LLC to each of their children. Without a LLC, the only way to make gifts of partial interests in the real property would be to execute deeds to the children each year, which would be a cumbersome, confusing process.

Valuation Discounts

When justified, minority interests in LLCs should be valued at something less than face value because the owner of a minority interest cannot realize the full value of his (pro-rata) company units if he/she were to sell them. In our example, assume Joe gifted 10 of the 500 units of the LLC to his son, Thomas. Thomas’ ownership of 1/50 of the LLC is subject to a substantial discount for several reasons including:

a. A discount for lack of marketability (i.e., who would pay full value for an interest in a company owned and controlled by family members).
b. A discount for lack of free transferability as the terms of the LLC restrict the ability of members to sell or otherwise dispose of their interests.
c. A discount of the interests of the limited members because management control in the hands of the managing member
d. A minority interest discount (for lack of control).

Typically, the terms of the LLC agreement are carefully designed to maximize the ability to take a (valuation) discount. Potentially, a discount can be taken both at the same time ownership units are gifted from one member to another and at the death of a member on his remaining ownership units. A successfully taken discount can result in a large estate tax savings.

Discounts can potentially be taken at the time a gift of a company interest is made from one member to another and also upon the death of a member on his or her remaining operating interest. Many factors, including the terms of the written operating agreement itself as well as thetype of assets owned by the LLC, contribute to the determination of the appropriate discount to be applied. It is very common to see a discount between 30-40% and higher discounts have been successfully applied to interests in LLC interests.

Using the Discount(s) with Annual Gifts: Under current tax law, the annual exclusion to gift taxes permits a donor to give up to $12,000 per year to as many donees as he chooses. Thus, if each company unit is valued at $1,000, a member could gift 12 units to each other member and have each gift qualify for the exclusion. However, if a 33% discount is taken on the value, the donor member could gift 17 units to each other member and still have each gift qualify for the annual exclusion. This helps to reduce the value of the donor's taxable estate more rapidly, thereby reducing the amount of estate taxes that may be owed upon his death. The impact of the discount applied to annual exclusion gifts can be significant if annual gifts are made for several years. However, to qualify such gifts of LLC units for the annual exclusion, the LLC agreement must be carefully drafted. The agreement cannot unfairly restrict a member's ability to sell or assign his company interests or allow a member to act against the best interests of the other members, such as withholding income distributions without a valid business purpose.

Using the Discount(s) at a Member's Death: An LLC can produce a large estate tax savings in that a discount potentially can be taken on an ownership interest owned by a member at his/her death. For example, if a member owns 750 units each valued at $1,000 at his/her death, the deceased member's estate would include $750,000 of units with not discount. If a (combined) 33% discount were successfully taken, the estate would only include $495,000 of units, which will reduce estate taxes by approximately $127,500 for an estate being taxed in the 50% tax brackets (federal and state combined).

The specific circumstances surrounding each LLC must be evaluated when deciding how much of a discount can reasonably be taken. The IRS may challenge the amount of a discount so tax savings are not guaranteed.

Business Appraisal and Valuation

It is highly recommended that investors and their attorneys seek the guidance of a qualified Business Appraiser. With Counsel's assistance, the Business Appraiser will be able to identify

and then quantify the applicable valuation discount(s) that may apply to a particular LLC and its membership. A carefully crafted Operating Agreement will spell out the necessary factors that limit or enhance the restrictions which are relevant to the considerations of management, control or lack thereof, distributions, risks, alienability and marketability of interests within the Company.

Standards of Value

When asked, "What is the value of the business or the business interest?" the proper response is "It depends on how the valuation is to be used or what the intended purpose is." It is often said that value, similar to beauty, is in the eyes of the beholder. This description can be further clarified by adding that value is dependent on how the opinion or estimate of value is to be used and who is using the opinion or estimate. This issue has led the valuation profession to establish a method or effective way to communicate this very important distinction. The solution developed by the profession is the concept of "Standard of Value". The intended purpose of the valuation is generally the determining factor as to what is the most appropriate standard of value to be applied in the circumstances. Over the years one of the most disagreed upon areas involving the theory of valuation is the appropriate application of the standard of value. Again, as mentioned previously, the proper selection of the standard of value will result in the proper selection of approaches to valuation, methods and variables applied in the valuation process. The following are several of the most often encountered standards of value:

- Fair Market Value
- Fair Value
- Investment Value
- Strategic Value (included in Investment Value)
- Synergistic Value (included in Investment Value)

Fair Market Value

Fair Market Value (FMV) is the most often used and referred to standard of value applied in the profession. The first definition of FMV occurred in June 1958, when Internal Revenue Code, Section 2031 was published. Section 2031-Definition of Gross Estate defined FMV as follows:

Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) "define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant fact".

Therefore, FMV is the statutorily defined standard of value for most tax related valuations. In addition to this statutory definition, the tax courts have further clarified several issues in the definition. These clarifications are as follows:

- Both "willing buyer" and "willing seller" are hypothetical.
- Resulting Value assumes terms of seller being cashed-out.
- Both hypothetical buyer and seller are assumed to be able.

Therefore this standard of value's definition would include the need to discount the initial estimate of value by any discounts for lack of marketability and minority interest that may be applicable.

This definition assumes payment in cash or its equivalent. If payments were made on a different basis, adjustments might be necessary to account for the impact and perceived risk attributable to an alternative financing arrangement.

Among other factors, FMV valuation considers all elements of valuation listed in Revenue Ruling 59-60, which generally outlines the valuation of closely-held stocks and includes the following:

- The nature of the business and history of the enterprise;
- The economic outlook in general and condition and outlook of the specific industry in particular;
- The book value of the stock and financial condition of the business;
- The company's earning capacity;
- The company's dividend-paying capacity;
- Whether or not the enterprise has goodwill or other intangible value;
- Sales of the company's stock and the size of the block to be valued; and
- The market prices of stocks of corporations engaged in the same or similar lines of business whose stocks are actively traded in a free and open market, either on an exchange or over the counter.

In the absence of a real buyer and seller, or the lack of a stated intention by the holder to sell, assumptions must be employed in the determination of value. The LLC is valued on a stand-alone, fair market value basis assuming a hypothetical willing buyer and a hypothetical willing seller. The values presented herein do not consider any additional value that may be realized by a particular purchaser who benefits from specific synergies or economies of scale, which could not be identified or quantified for these purposes. The fair market value standard is applied to produce a reasonable proxy for the value of the LLC as of the date of this valuation.

EXCELLENT PLANNING OPPORTUNITIES: (i) the applicable exclusion for 2013 is $5,250,000 per individual ($10,500,000 for married couples) with a maximum estate and gift tax rate of 40%). Additionally, the GST Tax Exemption is $5,250,000 in 2013. The unified credit is $2,045,800.

Incredible leveraging of the applicable exclusion amounts for gift, estate and GST tax purposes exists through the use of one or more LLCs. For 2011, 2012 and permanently thereafter, the applicable exclusion amount (set forth above) can be increased by the unused exclusion amount of the last deceased spouse ("Portability").

2013 Adjustments are in for: (i) Exemption from IRS Levy; (ii) Kiddie Tax and how to avoid; (iii) IRC § 2032A statutory maximum; (iv) Annual Exclusion amount; (v) IRC § 6166 2 % portion amount.

Top marginal tax rate in 2013 for individuals, trusts and estates is 39.6%.

E. Holding Life Insurance Policies in an LLC

An LLC can own life insurance; however, the agreement should be drafted very carefully to avoid inclusion of the proceeds of a policy in the estate of a deceased member. This is a very real possibility when the insurance is on the life of the member. The Internal Revenue Service could take the position that a member's powers create "incidents of ownership" over the policy that cause inclusion of the proceeds in the general member's estate at death. This problem can most likely be avoided by careful drafting of the operating agreement to include specific language prohibiting a member from exercising any powers or ownership rights over life insurance on his life that is owned by the LLC.

Even if the “incidents of ownership” issue is resolved, there will still be included in the estate of the deceased member an amount of the proceeds equal to his/her percentage interest in the company. The use of an irrevocable life insurance trust (or ILIT) may be preferable for a number of reasons, including the greater probability that all insurance proceeds will be kept out of one’s estate for estate tax purposes.

F. For Venture Capital Projects and Corporate Joint Ventures

Venture capital (VC) is financial capital provided to early-stage, high-potential, high risk, growth startup companies. The venture capital fund makes money by owning equity in the companies it invests in, which usually have a novel technology or business model in high technology industries, such as biotechnology, IT, software, etc. The typical venture capital investment occurs after the seed funding round as growth funding round (also referred to as Series A round) in the interest of generating a return through an eventual realization event, such as an IPO or trade sale of the company. Venture capital is a subset of private equity. Therefore, all venture capital is private equity, but not all private equity is venture capital.

In addition to angel investing and other seed funding options, venture capital is attractive for new companies with limited operating history that are too small to raise capital in the public markets and have not reached the point where they are able to secure a bank loan or complete a debt offering. In exchange for the high risk that venture capitalists assume by investing in smaller and less mature companies, venture capitalists usually get significant control over company decisions, in addition to a significant portion of the company's ownership (and consequently value).

Venture capital is also associated with job creation (accounting for 2% of US GDP), the knowledge economy, and used as a proxy measure of innovation within an economic sector or geography. Every year, there are nearly 2 million businesses created in the USA, and 600–800 get venture capital funding. According to the National Venture Capital Association, 11% of private sector jobs come from venture backed companies and venture backed revenue accounts for 21% of US GDP.

It is also a way in which public and private sectors can construct an institution that systematically creates networks for the new firms and industries, so that they can progress. This institution helps in identifying and combining pieces of companies, like finance, technical expertise, know-hows of marketing and business models. Once integrated, these enterprises succeed by becoming nodes. A venture capitalist is a person that makes venture investments, and these venture capitalists are expected to bring managerial and technical expertise as well as capital to their investments. A venture capital fund refers to a pooled investment vehicle (in the United States, often an LP or ***LLC***) that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans. These funds are typically managed by a venture capital firm, which often employs individuals with technology backgrounds (scientists, researchers), business training and/or deep industry experience.

A core skill within VC is the ability to identify novel technologies that have the potential to generate high commercial returns at an early stage. By definition, VCs also take a role in managing entrepreneurial companies at an early stage, thus adding skills as well as capital, thereby differentiating VC from buy-out private equity, which typically invest in companies with proven revenue, and thereby potentially realizing much higher rates of returns. Inherent in

realizing abnormally high rates of returns is the risk of losing all of one's investment in a given startup company. As a consequence, most venture capital investments are done in a pool format, where several investors combine their investments into one large fund that invests in many different startup companies. By investing in the pool format, the investors are spreading out their risk to many different investments versus taking the chance of putting all of their money in one start-up firm.

Structure

Venture capital firms are typically structured as partnerships, the general partners of which serve as the managers of the firm and will serve as investment advisors to the venture capital funds raised. Venture capital firms in the United States may also be structured as limited liability companies, in which case the firm's managers are known as managing members. Investors in venture capital funds are known as limited partners. This constituency comprises both high net worth individuals and institutions with large amounts of available capital, such as state and private pension funds, university financial endowments, foundations, insurance companies, and pooled investment vehicles, called funds of funds

Similarly, many JVs are formed as public limited companies (LLCs) because of the advantages of limited liability.

G. LLCs in Lieu of Corporate Subsidiaries

Prior to the LLC introduction, corporations set up their subsidiaries as corporations also. Corporate tax filings can be very complicated, not to mention the corporate management bureaucracy. Filings for LLCs are much less complicated and easy to separate businesses into separate LLCs. No annual meetings are required for an LLC. Although the business liability of the LLC is separated from its corporate owner, the LLC is a disregarded entity for tax purposes, avoiding an additional tax return for the corporate owner.

An LLC is a relatively simple legal entity that gives its members the same liability protection as a corporation without the legal or financial complexities of a corporation. Because of its simplicity, an LLC can be a subsidiary of any other legal company structure. The chief benefit of creating a subsidiary as an LLC is that it does not present as many accounting issues as a corporation. One difficulty that may arise is that, after formation, it may not be as simple to sell portions of interest in an LLC as it would to sell portions of interest in a C corporation, as the defining characteristic of a corporation is that its equity exists in the form of easily transferable shares of stock. (Remember that parent S corporations must remain the sole owners of any S corporation subsidiaries.)

An LLC can hold a controlling interest in any other type of business entity except an S corporation. If it owns a controlling interest in another LLC, since both the parent and the subsidiary are pass-through entities, the full income tax burden rests on the members of the parent LLC and any members that own a minority interest in the subsidiary. If the LLC owns a controlling interest in a C corporation, that C corporation must file its own separate tax return, paying corporate income tax, before forwarding any profits to the parent LLC.

H. Q&A

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