Special benefits for family businesses, ranches, and farms

If 50% or more of a person's estate is property of a family business, ranch or farm, there is a special estate tax provision that allows a value reduction of the ranch, farm, or business property of up to $1,100,000. The valuation reduction for such property can be combined with the estate tax exclusion amount of $5,490,000 to protect up to $6,590,000 from estate tax at each death. If the requirements for valuation reductions are met, a total of $13,180,000 of ranch or farm or family business property can be protected from estate tax upon the deaths of the husband and wife. To accomplish this result, there must be children or other qualified persons willing to operate the ranch or business after the parents' deaths.

The family business value reduction has the following requirements:

* Prior gifts of the business property to family members do not count for the value reduction. Gifts of nonbusiness property within three years of death are brought back in to determine 50% qualification.

* The value reduction provision requires that 25% of the property be real estate.

* The value reduction provisions require that the decedent or a member of the decedent's family must have owned and materially participated in the business for at least five out of the eight years prior to the decedent's death.

* The property must pass to a qualified heir. Qualified heir is limited to family members for the value reduction provision.

* The qualified heirs must continue in material participation with the business for at least 10 years or the value reduction will be recaptured and estate tax will be due.

Family Limited Partnerships or Family Limited Liability Companies

A family limited partnership (FLP) or family limited liability company (FLLC) is an excellent device for parents to pass on a family ranch or family business to their children. These business entities provide a number of tax and non-tax benefits when they are used in a family business context.

Non-tax Benefits of FLPs and FLLCs. The non-tax benefits of limited liability companies and limited partnerships include separation of management and ownership, protection from creditors and prohibitions against transfer of interests, admission of new members, and forced dissolution.

<u>Separation of Management and Ownership</u>. Both an FLP and FLLC may be created with a separation of management responsibilities from ownership interests. The owners of a limited partnership are the partners and the owners of a limited liability company are the members. In an FLP, there are two classes of partners - the general partners and the

limited partners. The general partners have the management responsibility for the business and limited partners are not involved in the management of the business. The management of an FLLC can be structured in two ways. An FLLC can be set up with all members of the FLLC sharing the management responsibility or the FLLC can be created with separate managers.

With both an FLP and FLLC, the management responsibility of the general partners or the managers is not conditioned on the percentage of ownership held by these individuals. General partners of an FLP can own 1% or less of the business. The managers of an FLLC do not have to be members of the LLC or they can start out as members and later continue as managers even after they have sold or given away their ownership interests. This separation of ownership from management permits parents to give children an ownership interest in the family businesses or investments without management control. The parents can keep the FLP general partner interests or remain the FLLC managers while giving away the other ownership interests to the children. Management continuity can be preserved through the terms of the partnership or operating agreement. Management may be left in the parents until such time as a child has demonstrated the ability to become a general partner or manager. As the children mature and are ready for increased responsibility in the business, the parents can begin to share management responsibility with some or all of the children. This ability to separate management and ownership and gradually increase management responsibilities can also be used to encourage initiative and teach business and investment skills.

<u>Gifting Flexibility</u>. FLPs and FLLCs also offer flexibility in gift giving. Giving fractional interests of real and personal property can be difficult. When the assets of a family ranch or farm are owned by an FLP or FLLC, a gift of a fractional interest can be made by a transfer of a percentage of ownership in the FLP or FLLC. The transfer can be done by amending the partnership or operating agreement without the need to prepare or record a deed. Also, unlike outright gifts of interests in land, the parents retain control of the gifted assets through their role as the general partners or managers.

<u>Creditor and Divorce Protection</u>. Both FLLCs and FLPs provide asset protection from creditors and divorce. If children are given direct ownership rights in assets, the creditors and spouses of the children will be able to assert rights against the assets in the event of bankruptcy or divorce. Further, if the child dies, the asset may pass to someone unexpected. If the assets are owned by an FLP or FLLC and the children are transferred ownership rights in the entity, the assets are protected. Prohibitions against transfer or assignment of partnership or membership interests and a right of first refusal are included in the organizational documents of the FLP or FLLC to avoid an assignment or transfer of the interest to creditors or a spouse. If an FLP or FLLC ownership interest is transferred to or attached by a creditor or ex-spouse in violation of the provisions, the person acquiring the interest only becomes an assignee under Wyoming law. An assignee does not have any right to participate in the business, share in the assets of the business, or force a dissolution of the business. The assignee only has the right to the share of income the original owner would have been entitled. Distributions of income from an FLP or FLLC are controlled by the general partners or managers and there is no ability to

force a distribution of the income. The result is the assignee will be subject to income tax on a share of income, but may not receive any distributions of that income.

Restrictions on Transfer, Withdrawal, and New Members. Both an FLP and FLLC may be formed with restrictions prohibiting transfer of ownership interests, withdrawal of members or partners, admission of new partners or members, and withdrawal of a partner or member's capital contribution. Usually, the organizational documents of both an FLP and an FLLC prohibit transfer of ownership, withdrawal of a member or partner, or admission of a new member or partner without the unanimous consent of all existing members or partners. The organizational documents can also require the unanimous consent of the general partners or managers for any transfer, withdrawal, or admission of a new member or partner. Also, a partner or member has no right to withdraw his or her capital contribution or percentage share of the entity's assets. These requirements may be coupled with an optional or mandatory right of first refusal requiring any partner or member wishing to withdraw or sell his or her interest to first offer the interest to the other partners or members at a discounted price with extended terms favorable to the remaining partners or members.

Limited Liability. Limited liability protection is available to the owners of both FLPs and FLLCs. All the owners of an FLLC are afforded limited liability protection. Only the limited partners of an FLP are given such protection. Limited liability means an owner's liability to the creditors of the business is limited to the contribution or ownership interest the owner has in the assets of the entity. Creditors of the business cannot come after the personal assets of the owner. The exception is the general partners of an FLP. Such general partners have unlimited liability with respect to the creditors of the business and creditors of the business can come after the general partners' assets outside the business.

Probate Avoidance. Some degree of probate avoidance is possible with an FLP or FLLC because an interest in both entities is personal property. The assets of the entity will not be subject to probate - only the ownership interest in the entity. The ownership interest can easily be assigned to a revocable trust to avoid probate entirely.

Tax Benefits. The tax benefits of an FLP or FLLC derive from the same restrictions on transfer of ownership, withdrawal of contributions or shares of ownership, and the separation of management and ownership causing the non-tax benefits of these entities.

Reallocate Business Income. Both FLPs and FLLCs afford some opportunity to allocate the entity's income to family members in lower tax brackets or those most in need of such income. Gifts of percentage interests in an FLP or FLLC carry with the gift an allocation of the percentage interest of the entity's taxable income. The managers or general partners also control the amount and timing of distributions of the entity's income to the members and limited partners. General partners and managers are entitled to compensation for the services they render to the entity and may be paid a management fee or salary for such services regardless of their ownership interest. General partners and managers may employ children or other partners or members in the business and pay them a salary. General partners and managers may also withhold distributions for anticipated future expenses and capital expenditures of the business. By paying themselves a salary, paying children or other partners or members for working for the business, and exercising their discretion to withhold distributions of income for future expenses, the parents, as general partners or managers, can make distributions to reward productive labor and withhold distributions when children or other partners or members are not contributing or showing maturity.

Discounts in Value of FLP or FLLC Interests. Restrictions on transfer of ownership interests, separation of control from ownership, and fractionalization of ownership interests among family members allow discounting of the value of FLP or FLLC ownership interests for estate tax and gift tax purposes. The discounts can bring a significant reduction in the value of an interest below what the interest would be worth if the owner of the interest were entitled to force a liquidation of the entity and demand a share of the assets equal to his or her percentage of ownership. Two major types of discounts are allowed. The first estate and gift tax discount is attributed to the ownership of a minority interest or a lack of control. This discount arises when ownership in the FLP or FLLC is split among family members in a manner so that no family member has a majority or controlling interest in the business entity. Second, there is a discount for lack of marketability. This discount comes from the restrictions in an FLP or FLLC on the withdrawal of ownership interests, admission of new owners, and transferability of ownership interests. Because of these restrictions, an outsider would not be willing to pay as much for an interest in the entity. Valuation of business interests for estate and gift tax purposes is based on what a willing buyer would pay for the interest being gifted or left in a person's estate.

Combination of Discounts. If the parents originally controlling an FLP or FLLC gift away their interests in the FLP or FLLC to the children gradually, each gift is entitled to a discount in value because of lack of marketability of the gifted interest and the fact the gifted interest lacks control. Further, if a parent dies owning an interest in an FLP or FLLC, this interest may be discounted in value for both lack of marketability and for lack of control. The sum total of these discounts can be 40% or higher. Discounting of FLP or FLLC interests is more important when the value of the family business before the discount exceeds two times the applicable exclusion amount. The applicable exclusion amount is the amount each person can give away during life or pass at death without paying an estate or gift tax. In 2017, the applicable exclusion amount is $5,490,000 per person.

Consideration of Income Tax Implications. Before using an FLP or FLLC to obtain value discounts for gift or estate tax, the income tax implications should be considered. If an FLP or FLLC is structured to maximize valuation discounts, the step-up in the income tax basis of an FLP or FLLC ownership interest on the death of the owner of the interest will be reduced. This reduction in ownership interest basis step-up will also carry over as a reduction in the amount the assets of the FLP or FLLC may be stepped up due to the death of an owner. The reduction in income tax basis step-up due to valuation discounting may result in greater income tax liabilities for the beneficiary of the deceased’s FLP or FLLC ownership in the entity. If estate tax discounting is no longer required, it may be appropriate to terminate an FLP or FLLC before the death of the parents or to change the terms of the partnership or operating agreement to lessen or eliminate some of the transfer and control restrictions.

Comparison of FLP and FLLC. In most aspects, FLPs and FLLCs are very similar. A family business may operate under either entity. The main advantage of an FLLC over an FLP is that all owners of the FLLC are protected from the liabilities of the business, including the managers. On the other hand, the general partners of an FLP have unlimited liability. Another advantage of an FLLC is that it is easier to gradually involve the children in the management of the entity. A member can be appointed a manager without any change in ownership interest in the FLLC or any change in his or her liability with respect to the entity. In order to give a limited partner a management role in an FLP, the partner will have to be given a general partnership interest in the entity. Along with the general partnership interest, the former limited partner gives up limited liability and subjects his or her personal assets to the liability of the entity. This increased liability for general partners of an FLP can be avoided by incorporating each general partner, but this greatly increases the complexity of the family business. The main advantage of an FLP over an FLLC is that, in some states, limited partnerships may have greater statutory restrictions on transfer of interests, admission of new partners, and withdrawal of existing partners. These greater restrictions may permit greater discounts in value for gift tax and estate tax purposes. In Wyoming, there is little difference between the statutory restrictions for limited partnerships and limited liability companies on transfer of interests, admission of new members or partners, and the withdrawal of existing partners or members, if the limited liability company is formed as a Close Limited Liability Company. The Wyoming Close Limited Liability Company was specifically created for family business limited liability companies.