



Price & Farrington's

Estate Planning Tools and Tips

*Timely Information for Advisors
About Advanced Estate Planning
and Family Wealth Strategies*

Limited Liability Company



How do you provide business transition and asset protection planning, combined with estate planning? Create a Limited Liability Company (LLC).

The LLC is a state-created legal entity that is separate from its owners and, if properly structured by a competent attorney, combines the best business and tax characteristics of both the corporation and the partnership. An LLC may own property, incur debts, enter into contracts, and sue or be sued.

The properly-structured LLC offers its members the same limited liability and pass-through taxation that an S corporation or limited partnership can offer, but without some of the restrictions of these traditional entities. The LLC, with its greater operational flexibility, now challenges the S corporation as the entity of choice for the closely-held business and for other estate planning objectives.

Compliments of:

Price & Farrington, PLLC

Attorneys and Counselors at Law

12501 Bel-Red Road, Suite 215

Bellevue, WA 98005

(425) 451-3583



E-mail: contact@pricefarrington.com

Website: www.pricefarrington.com

Toll-Free 24-Hour Estate Planning Tips *Hotline*: 1.888.254.5450

INTRODUCTION

Entrepreneurs and their business and tax advisers have traditionally looked to the S corporation and the limited partnership to obtain the benefits of limited liability for the owners and pass-through taxation for their business. However, the S corporation is subject to relatively restrictive and inflexible shareholder and ownership requirements, and the limited partnership does not provide complete limited liability since state law requires that at least one general partner be available and responsible for entity obligations.

The limited liability company (LLC) as a business and estate planning entity combines many of the most favorable business and tax features of both the S corporation and the limited partnership without a number of their drawbacks. It is an operational structure that deserves consideration by entrepreneurs, their financial advisers and others involved in meaningful tax planning.

With few exceptions, every state has authorized the formation and the operation of an LLC within their borders. Significant federal and state tax guidance over the years has answered a number of the nagging taxation questions that previously caused entrepreneurs and their financial advisers to resist creating an LLC. Now, with such widespread acceptance and a growing comfort with its tax consequences, the LLC's offer of limited liability and flow-through tax treatment gives the LLC considerable business and tax planning opportunities.

WHAT IS THE LLC AND HOW IS IT FORMED?

The LLC is a state-created legal entity that is separate from its owners and that, if properly structured, combines the best business and tax characteristics of both the corporation and the partnership.

An LLC owner, called a "member", is shielded from the entity's liabilities which exceed the member's actual or promised investment, unless there are personal guarantees or waivers of such protection. An LLC member is usually vested by statute with management authority similar to that of a general partner of a partnership, but this power and responsibility is often delegated by the member to a select group of "managers." These managers, who may or may not be members, are then generally vested with the authority to make the appropriate and necessary business decisions for conducting the LLC's business.

Restrictions are generally placed on the transfer of LLC membership interests in order to maintain voting control within a certain group of investors. An LLC ordinarily does not possess a perpetual life, dissolving after a given time period or after a member's interest is terminated. Most state LLC laws provide standards by which the remaining members may continue the business.

The LLC may be created, owned and operated by one or more members. These members may be individuals, corporations, partnerships, trusts, other LLCs, and/or any other type of

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legal entity. The organizers of the LLC generally must file a “certificate of formation” with the appropriate official of the state (usually the Secretary of State) in which the LLC is formed.

The certificate of formation, analogous to a corporation’s articles of incorporation, typically includes, among other provisions: the name of the LLC; its period of duration; the address of its place of business; the name and address of an initial registered agent; and the names and addresses of any LLC managers.

Although often not required by statute, good business sense dictates that an LLC also have an “operating agreement”. The operating agreement, conceptually similar to a partnership agreement and the bylaws of a corporation, governs the LLC operations and the rights and duties of its members and managers. The agreement also addresses such matters as voting and distribution rights, transferability of interests, management structure, withdrawal of a member and dissolution of the LLC.

State LLC laws are typically drafted with assorted default provisions which furnish the key rules of operation that will govern the LLC in the absence of a contrary operating agreement provision. By drafting an operating agreement the member themselves, and not the state legislature, are able to decide certain outcomes.

HOW DOES THE LLC COMPARE TO AN S CORPORATION AND A LIMITED PARTNERSHIP?

Choosing the correct operational entity for a business, investment or estate planning vehicle is a crucial decision, requiring an analysis of both business and tax factors. The opportunities and disadvantages which apply to the various entity choices must be carefully examined.

Significant business considerations, such as the operational maturity of the enterprise, the financial wealth of the investors, the number of investors, the types of ownership interests that will be made available, the presence of family members, as well as tax consequences, must be scrutinized.

When choosing an entity for business operations, entrepreneurs and business and tax advisers have traditionally looked to the S corporation and the limited partnership to provide the investing owners with limited liability and pass-through taxation. The properly structured LLC now offers its members the same limited liability and pass-through taxation that an S corporation or limited partnership can offer, without some of the restrictions inherent in these traditional entities.

THE LLC AND THE S CORPORATION

The LLC possesses the tax and non-tax advantages of the S corporation as a means of operating a closely-held business. Any comparison between an LLC classified as a partnership

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and as an S corporation largely focuses on their comparative federal tax treatment. The following items are most significant:

- The LLC is free of the numerical and shareholder ownership restrictions of an S corporation.
- The LLC is more flexible in terms of structuring different types of ownership interests where the S corporation is limited by the requirement of a single class of stock.
- The LLC has tax advantages over the S corporation relating to the contribution and distribution of property, especially the distribution of appreciated property to members.
- Tax losses are more easily passed through to an LLC member than to an S corporation shareholder because of the more favorable rules relating to the tax bases of LLC interests.

The LLC, with its offer of more complete pass-through tax treatment and its greater operational flexibility, is a powerful alternative to the S corporation as the entity of choice for business and estate planning.

THE LLC AND THE LIMITED PARTNERSHIP

Although the LLC taxed like a partnership and the limited partnership do not differ significantly for tax purposes, the LLC does have the following two non-tax advantages over the limited partnership:

- The LLC has no equivalent to a general partner who has unlimited liability for the debts and obligations of the organization.
- An LLC member may freely participate in management, unlike a limited partner whose rights to participate are restricted by partnership agreement.

WHAT ARE AN LLC'S ADVANTAGES FROM AN ESTATE PLANNING PERSPECTIVE?

An LLC is desirable because of its flexibility. For example, unlike subchapter S corporations, there are no restrictions on the number of participants and complex trusts may become members.

Other advantages of the LLC include:

- The avoidance of S corporation restrictions on trust provisions after the trust maker's death.
- Basis adjustments that are not available to S or C corporations.
- The ability to distribute appreciated property to members without triggering gain to the members or income to the LLC.
- The ability to discount minority member interests just like limited partnership interests

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for both gift and estate tax planning purposes.

SUMMARY

While the LLC holds great promise as a means of carrying on business and investment opportunities, the business law pertaining to the LLC is developing, and the application of federal and state tax law, while becoming clearer, is still sometimes cloudy. Given the opportunities and the complexity of some of the issues involved, we recommend that you meet with an attorney in our office after reviewing this summary to see if the LLC format might be a feasible option for your own business operations or to achieve your estate planning goals.



Where do you go from here? A good place to start is by contacting our law firm at 425.451.3583. We would be pleased to discuss with you the powerful opportunities offered by the LLC as a business, tax, asset protection and estate planning tool.

Price & Farrington, PLLC

Attorneys and Counselors at Law

12501 Bel-Red Road, Suite 215

Bellevue, Washington 98005

Telephone: 425.451.3583

Facsimile: 425.452.0153

E-mail: contact@pricefarrington.com



At Price & Farrington, PLLC
we focus exclusively on
client-centered Estate, Tax, Retirement
and Asset Protection Planning.



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