

## The Series FLLC: Copasetic Estate Planning for the 21<sup>st</sup> Century?

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Forms of business are chosen for multiple reasons and keep evolving to meet modern needs. One of the newer forms is the Series LLC that allows many separate assets to remain as separate “cells” of the umbrella LLC for liability purposes, yet remain one single LLC, with a single tax return, for tax purposes.

A Series LLC could be a very useful vehicle for many estates, providing an estate with an organizing principle that is simple and effective. A family limited liability company using this approach may have many additional advantages.

Let’s review the specifics of the Series LLC, compare it to other forms of business, and consider how this arrangement may be useful in the current uncertain context of estate planning. Let's also take note of the potential problems of any new technique.

### **The Family Business Estate**

A business is like a gold mine in that it produces wealth that the business owner accumulates. The business may also provide financial stability in the form of jobs, tax benefits, and other perquisites to family members. What happens when the owner dies? When the business assets pass through the owner’s estate there are threats to the business itself from lack of continuity, loss of the managing partner, lack of liquidity, the potential distraction of probate proceedings, and the uncertainty of valuation.

Having the right form of business becomes an absolutely critical choice in addressing these and other issues. Once upon a time there were limited business entities. There was the sole proprietorship, the partnership, and the corporation (a “C” corporation).

For example, a traditional partnership with a general partner managing the business and limited partners sharing in certain income can be a simple way to operate a business. A partnership is a pass-through entity for tax purposes. And because the division of business interests among partners can discount a minority share, the original owner’s remaining share of a business can be passed at death with a discounted value for estate tax purposes. The downside: A partner’s personal liability could exceed the amount the partner contributed to the business.

For greater liability protection for the owner’s personal assets, the corporation (a “C” corporation) has been the traditional choice for many years. The C Corporation is a separate taxable entity.

Then variations arrived to mix and match various features of different arrangements. S corporations made it possible to have the limited liability of a C corporation but the pass-through tax status of a partnership. And limited liability companies made it possible to have a) the liability protection of a C corporation, b) the pass-through tax status of a partnership or S corporation, and c) simplicity and freedom from the restrictions applicable to S corporations.

### **Business Firewalls**

The traditional concept of a business owner with a single widget factory operating as a traditional corporation, Widgets Unlimited, Inc., is no longer the profile of what passes through modern estates.

People with wealth now have excellent advice and excellent opportunities. The modern wealthy family typically ends up with a diversified number of assets. Multiple types of assets. Multiple real estate properties. Multiple investments, insurance policies, pension accounts, trust arrangements, collectibles, and intellectual properties.

The modern estate now contains separate entities for each major asset. Someone who invests in a movie project will incorporate that venture as a separate entity. Someone buying three rental properties will typically incorporate each building as a separate entity for liability purposes. As new income is generated, funds are transferred to trust accounts and investments that may also be separate entities.

The net result is a strategically diversified collection of assets with excellent liability firewalls separating them and, hopefully, complementary tax planning.

Unfortunately, the net result of all these discreet entities may be a lot of administrative expense. Various arrangements that various advisors recommended at various times can mean higher levels of accounting, legal, and management burdens that are associated with so many different entities.

An estate of \$20 million, for example, may have three or four significant assets to keep track of. But what many people find as their wealth increases, they double their wealth, but quadruple their headaches. Paperwork and problems keep adding up until more staff is necessary.

For those with enough money, say, \$500 million, the “family office” approach becomes feasible. For \$1 million a year, a professional in-house staff can take care of family assets and responsibilities.

But for those people with assets of \$50 million, \$100 million, or even \$300 million, annual revenues many only justify a more modest version of a family office that relies upon outside professionals trying to contain the sprawling burdens of many assets.

### **A Talented Umbrella: The Series LLC**

Limited liability companies (LLCs) were introduced in the United States about 30 years ago in response to similar entities arising in Latin America and Germany. Wyoming led the way in 1977. For a number of years, the LLC was considered somewhat “new” and that was a potential drawback, but by 1996 it was accepted in all 50 states.

Today, limited liability companies have been fully vetted and are available with many variations.

One of the newest versions, the Series LLC, may provide a timely and useful solution to the 21st century estate. A Series LLC allows each of the various entities in an individual's estate (or a family's estate) to be gathered up and administered in one entity for tax purposes, while retaining the separate status of each entity for liability purposes.

Remaining assets such as bank accounts, brokerage accounts, mutual funds, bonds, annuity investments, and insurance policies can be placed into a "family savings LLC" that further shields even those assets from liability and that LLC can be another cell that is managed under the umbrella of the Series LLC. In this way, a Series LLC is essentially operating as "the poor man's Family Office" i.e., a scaled-down family office for families with somewhat less than \$500 million.

The Series LLC involves a master LLC that files one income tax return despite having multiple "series" or "cells" consisting of separate LLCs or other entities. Debts, liabilities, and obligations of one Series are only enforceable against that Series. A Series can be added or deleted from a master LLC.

The Series LLC originated in Delaware in 1996. Since 2005 there has been a flurry of interest and enabling legislation for Series LLCs has been enacted in Illinois, Iowa, Oklahoma, Nevada, Tennessee, and Utah. A streamlined version of the Series LLC was enacted by Wisconsin. A Series LLC that is formed in one state cannot be used in another state unless it first applies and is qualified by such other state. Once qualified to do business in the non-formation state, the Series LLC may become subject to the laws of that non-formation state.

*Caveats:* This is a relatively new and untested technique. California has indicated that each Series of a Delaware Series LLC must report and pay taxes separately in California. There is some speculation that highly correlated assets, members, and managers may be required to justify single entity federal tax treatment.

And for liability protection purposes, maintaining the separate identity of each Series is relevant. Each Series should have its own name, contracts, and bank accounts. Funds should not be commingled between Series and transactions between Series should be at arm's length with appraisals. Even then, there are unanswered questions about whether creditors in a non-formation state who have not consented to be bound by Series provisions would be legally bound. Having every tenant, vendor, and employee sign agreements to be bound by the Series provisions would be advisable until the non-formation state develops its own legislation or case law on Series LLCs.

### **Example: Buying Out Rita**

Ruth and Rita, daughters of a Widget magnate, have invested in six commercial and residential buildings. Each retains shares in the family Widget business. Each has other assets to be managed. But Rita, a free spirit with no children, wants to be free of the entire headache of the assets and their management. Ruth, however, has been involved in running some of the real estate properties. She also has three children, with large trust funds, investments, and other assets.

Ruth is at the crossroads. What are her options? (1) Join with Rita, get appraisals, sell all the assets to the highest bidder and invest all the proceeds in safe investments. (2) Buy out Rita with her own assets and continue without her. Or (3) Have her children buy into the family assets and reorganize the whole package. There are pros and cons to be weighed for any of these approaches.

For the first option, joining with Rita and selling to the highest bidder might generate the most money, but only if the timing is right. If the market for those buildings has fallen off, then selling right now would not make sense. This forfeits current value as well as future appreciation.

Capital gains could also be a problem if there were significant gains. By selling now instead of having the property pass through their respective estates to beneficiaries with a stepped-up basis, there is an added cost to selling out.

There is also an investment component to this decision—will the proceeds of the sale generate more funds than the business and real estate investments? These assets have generated a great deal of annual income while appreciating in value, and all the while have been purchasing health insurance and other benefits with pre-tax dollars for the partners. Once Ruth sells the gold mine, there will be no more gold, just standard bank and investment accounts.

Option #2 enables Ruth to buy out Rita and then leave the assets to her children with a stepped-up basis. The downside is being left with all the responsibilities while Rita goes off happy and free.

Option #3 is rife with possibilities:

**DISCOUNTED VALUE:** Rita can't force Ruth to sell and this limits the market of buyers. Lots of people want to buy a Widget Factory or a commercial building but far fewer would like to jump into a long-standing family business and be partners with Seller's sister. That means Ruth's children, as buyers, are entitled to a discount when purchasing Rita's assets.

**CAPITAL BASIS:** The buyers will use the purchase price as their basis for future capital gains purposes. This leaves them in a favorable position, as opposed to Rita who is going to incur a capital gain. If any of the children need to sell their shares, they will have a higher capital basis in the property.

**A GOOD USE FOR TEEN ASSETS:** Custodial accounts and trust accounts that are getting ready to disburse funds to young adults can be a parent's worst nightmare. Uniform Gifts to Minors Acts (UGMA) from certain states, such as New York, once had age 18 as the default date for disbursement of custodial accounts.

Currently, Uniform Transfers to Minors Acts (UTMA) tend to use age 21 as majority age. But either way, parents who envisioned their offspring being imbued with precocious wisdom at age 18 or 21 may have what author Kaye A. Thomas terms "UTMA regret" when it comes time to hand over funds to an immature young person.

One approach is to invest the funds in something that is long-term and worthwhile. Ergo, using various assets as they become available (as permitted under trust terms or with consent of offspring as they reach consenting age), makes it possible to protect liquid assets that a youthful person might expose to creditors or spend on extravagances. These assets can be redeployed to sustain the family's engines of wealth.

**SOUND ESTATE PLANNING:** At Ruth's death, she will own only her half of the assets, and the value of such assets will be entitled to the same type of marketability discount that applied when the children purchased Rita's interests. The same concepts that make a family limited partnership (FLP) valuable are present here, working their magic.

Assets owned by Ruth will pass through her estate to her heirs with a stepped-up basis—something that is possible with LLCs. (This assumes that the planned carry-over basis will not be implemented in 2010.) Meanwhile, new assets produced by the family business can be directed away from Ruth and into longer term trusts for children and grandchildren, some of which can be funded with life insurance. In fact, the LLC can be partially owned by a trust.

**WE ARE FAMILY:** A parent and children owning business assets together can make for employment opportunities, health insurance coverage, and a level of trust and teamwork that is extremely valuable. The net effect of this approach is to keep the assets of Ruth and her three children intact for future generations. Assets about to break off into the children's individual funds are instead reinvested in the family enterprise.

**A REORGANIZED APPROACH:** As long as changes in ownership are being made, there are opportunities to simplify business operations and increase profitability wherever possible. This is where a Series LLC can come in very handy.

**FLEXIBILITY:** A Series LLC (or FLLC) offers a centralized administration for diverse assets, yet retains separate "cells" for liability purposes and allows separate assets to be liquidated or added to the overall LLC. The LLC members can have a limited involvement in management without suddenly losing liability protection as might occur with a limited partner in an FLP. The flow of assets through the LLC can be regulated in ways that isn't proportionate to ownership of shares. And as tax laws change in the future, the Series LLC can adapt along with them.

### **A Window on the Future?**

Have we just been treated to a glimpse of the future of estate planning? Is the Series LLC (or FLLC) the direction for the modern multi-dimensional family portfolio of businesses, real estate, and other assets?

Perhaps that requires a leap of faith. Remember, hard and fast solutions don't work in business, nor in estate planning. Every estate is different. Moreover, until the liability firewalls of a Series LLC are certain, moving business AND family assets from multiple generations into a Series FLLC may be placing too many eggs in one risky basket.

There are other potential limitations as well. For example, the ability of LLC participants to share losses may depend on whether they are "active participants" with more than 500 hours a year as a member of the entity. If the family estate has fewer actively managed business components, an argument might be made for using a family limited partnership (FLP) for estate planning purposes.

Still, for the right family, in the right jurisdiction, with the right real estate or other assets, the Series FLLC may be a copasetic solution that meets business, tax, liability, family, and estate planning needs.