

The Limited Liability Company - Today's Entity of Choice

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There are many reasons why the limited liability company ("LLC") has become the entity of choice for many business owners. Such reasons include limits on liability, favorable tax treatment, protection from creditors and its suitability for succession planning.

OWNERSHIP OF COMMERCIAL REAL ESTATE

In general, any liability stemming from a business operated within an LLC does not give rise to individual liability to the owners (members) and managers of the LLC (except for their own negligent acts). Thus, contrary to the liability exposure to which trustees and beneficiaries of certain trusts are subject, the LLC insulates its members and managers from liability stemming from the LLC operation. For this reason, LLCs are an excellent vehicle for owning commercial real estate which usually generates a substantial risk of liability, i.e., tort-based, environmental, contractual, etc.

In addition, whenever real estate is owned by an individual at death, the probate process can cause a delay in the re-titling of the property to the heirs, or in the sale of the property to third parties. Where the property is owned by an LLC, many of these delays and complexities disappear.

FAVORABLE INCOME TAX TREATMENT

In the mid-1990's, the IRS pronounced that it would allow "flow-through" income tax treatment for limited liability companies, putting them on par with partnerships and, to a large extent, subchapter S corporations in Massachusetts and Delaware. In general, flow-through treatment means that the LLC files only an informational return. The bottom line net profit or net loss is reported by the owners on their personal returns according to their percentage ownership in the LLC. In this way, the LLC does not pay an entity-level tax.

PROTECTION FROM CREDITORS

LLCs also offer some amount of protection from a member's personal creditors by prohibiting such creditors from seizing the member's LLC shares to satisfy the member's obligation. Similar ownership interests in certain trusts and corporations are subject to seizure by a beneficiary's or shareholder's creditors. At best, LLC member's creditors may obtain a charging order from the courts to intercept any profit distributions, when and if made by the LLC to the member.

SUCCESSION PLANNING

Sophisticated estate plans typically utilize arrangements which facilitate the gifting of assets to the next generation at a discounted value to reduce the ultimate taxable estate. For example, individuals are allowed to make tax free gifts of up to \$14,000 annually to anyone they choose. If a discount of, say, 35% is applied to the gift, then \$21,538 could be gifted to each person because the discounted value would not be more than \$14,000.

For example, assume that a married couple with three adult children establishes a Delaware LLC and transfers \$500,000 of real estate into it in exchange for 100% of the outstanding shares. The couple could make annual tax-free gifts of stock to their children. Since the children's shares would not be freely transferable and would not give any one child control over the LLC, applicable tax law may allow us to apply a 35% discount to the value of the shares for purposes of determining the amount of the taxable gift. This allows each parent to give a 4.3% interest in the LLC to each child each year (\$21,538 per year = \$14,000 net after a 35% discount is applied). In this manner, the couple can gift \$129,228 worth of LLC shares each year to the children, gift tax-free (\$21,538 x 3 children x 2 parents = \$129,228). In just a little over four years, the property could be gifted away, tax-free.

Alternatively, the parents could choose to retain all of the voting shares to retain control of the entity until their deaths and then leave the voting shares to the children in their wills/trusts. This may be particularly desirable where the parents have the expertise to run the business or manage the real estate, and the children do not. The beauty of gifting through an LLC is that the annual gifts are accomplished with a one-page document signed and filed with the LLC organizational documents. No further recordings at the Registry of Deeds are necessary.

In summary, LLCs offer a number of practical advantages as well as tax benefits over other types of entities. If you would like to explore how an LLC might benefit you in your business or personal planning, feel free to call one of the attorneys in our Business and Corporate Practice Group for a consultation.

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