SAGE Solutions

The Deferred LLC

By Alan Brown, JD, and Eric Mann, JD, CPA

<u>Introduction</u>

The Deferred LLC is an estate planning technique that generates deferred performance inside a freeze partnership. The Deferred LLC is an ideal place to purchase and maintain assets that do not produce current cash flow because none of the Deferred LLC's assets flow back to the owners for at least 20 years.

The Deferred LLC, which precisely follows IRS rules, also provides the following additional benefits:

- Freezes the value of the parents' invested assets and shifts appreciation to the parents' children.
- Enhances asset protection.
- Weathers the ups and downs in the financial markets better than other estate planning techniques.
- Succeeds whether or not the parents survive the term.
- Increases the effective rate of return of the invested assets, since the parents pay income tax on the taxable income of the Deferred LLC whether or not distributions are made to them (the same as a "grantor trust").

<u>Deferred or Immediate</u>

Many popular estate planning techniques established by parents for their children require that the original contribution, plus a fixed rate of return, must return to the parents beginning in the first year. For example, in a grantor retained annuity trust (GRAT), annual annuity payments, equal to a percentage of the invested assets and a fixed rate of return established by IRS tables, must be made to the grantor of the trust during the first year and each year thereafter until the end of the GRAT term. Similarly, in a sale to an intentionally defective grantor trust, interest and principal payments typically are made annually to the seller. In a charitable remainder trust, annuity or unitrust payments must be made to the donor each calendar year. Finally, in a typical freeze partnership, periodic qualified payments must be made to the partner holding the frozen partnership interest.

In the Deferred LLC, no payments need to be paid to the parents for 20 years.

If you would like to forward this article via email, please click here.

Sage Hill Advisory & Management
18 Division Street
Suite 303B
Saratoga Springs, NY 12866
Main: 518-871-1214
www.sagehilladvisory.com

SAGE HILL
Advisory & Management

Freeze Partnerships

The structure of a Deferred LLC is similar to a freeze partnership. Freeze partnerships are partnerships or limited liability companies (LLC) that “freeze” the federal gift and estate tax value of the parents’ contributions. A typical freeze partnership is structured as follows:

- Parents contribute $5 million dollars to an LLC in exchange for a cumulative preferred member interest. The trust established by the parents for their children contributes $1 million for the common member interest.
- As the holder of the preferred interest, the parents are entitled to receive the first cash flow distributed, if any, up to a fixed amount. Any appreciation greater than the fixed amount passes gift tax free to the children’s trust.

Before the enactment of Section 2701 of the Internal Revenue Code of 1986, as amended (the “Code”), families often abused this structure by never making any payments from the freeze partnership to the parents. By not making these payments, the parents shifted tremendous amounts of value to their children at a low gift tax cost.

In 1990, Congress curbed these abuses by enacting Section 2701 of the Code, which requires the preferred interest holder to actually receive periodic payments. If the parents as the preferred interest holders fail to receive these payments, they are treated as having made a taxable gift of all of their ownership interests, including their retained frozen interests.

The Deferred LLC has all of the benefits of a freeze partnership, except that periodic payments are not required. Instead, when the Deferred LLC is established, a full redemption of the parents’ ownership is locked in for an amount set by independent appraisal.

Section 2701 of the Code does not apply to a Deferred LLC

If structured and administered properly, the Deferred LLC is not subject to Section 2701 of the Code. A typical Deferred LLC is organized as follows:

- Parents contribute assets to a Deferred LLC in exchange for a nonparticipating class of member interest with required redemption provisions.

- Parents will own a class of member interest that mandates its redemption on specified dates at specified dollar amounts. The Deferred LLC is not required to make any other payments to the parents.
- The redemption amounts are set in advance and are designed to reflect a preferred return similar to a "zero-coupon" bond.

The Deferred LLC is designed so that the parents only retain a "mandatory payment right." A mandatory payment right is defined as a right to receive a payment required to be made at a specific time for a specific amount. The use of a mandatory payment right exempts the Deferred LLC from the harsh rules of Section 2701 of the Code.

<u>Rate of Return on Preferred Interest of the Deferred LLC</u>

When forming a Deferred LLC, each owner must receive an interest in the LLC with substantially the same fair market value as the fair market value of the assets the member contributes to the LLC. As a result, the parents must receive a fixed rate of return on their contributions of capital to the Deferred LLC. The rate of return should be established by an independent appraiser.

A payment due in 20 years is economically the same as a 20-year zero coupon bond and the accumulated rate of return is economically the same as the bond's coupon. An appraiser can find good market comparables for the rate of return for the mandatory payment right.

If the assets of the Deferred LLC appreciate faster than the rate of return on the mandatory payment right, then the excess appreciation shifts to the children's trust. Since all the assets are retained in the LLC for at least 20 years, the likelihood of achieving this goal is substantially increased.

<u>More Certainty with a Deferred LLC and other Benefits</u>.

No Survivorship Requirement. A properly structured Deferred LLC is less vulnerable to attack and operational hurdles than most estate planning techniques. The donor to a GRAT must outlive the term of the GRAT to achieve any federal gift tax benefit regardless of the amount of appreciation. The seller to a grantor trust must outlive the promissory note's repayment date to avoid possible recognition of gain. The death of any owner does not end a Deferred LLC. The deceased owner's heirs or successors become the new owner and the Deferred LLC continues to operate.

No Discounts Required. Gifts and sales of family businesses like family limited partnerships depend on gift tax valuation discounts that the IRS has challenged

SAGE Solutions

aggressively. The Deferred LLC requires no valuation discounts. The one valuation issue, the rate of return for the mandatory payment, is set by an appraiser using widely available market comparables.

Federal Estate Tax Return Friendly. If a parent dies before the parent's ownership is fully redeemed, the parent's estate will report the parent's remaining mandatory payment right as an account receivable from an ongoing business for federal estate tax purposes. The estate tax valuation should be straight forward.

Liquidity Available. If liquidity is needed to pay estate taxes nine months after the parent's death, the Deferred LLC agreement permits the prepayment of some or all of the mandatory payment right before year 20. The Deferred LLC can use any assets for this prepayment.

Added Asset Protection. A Deferred LLC provides a tremendous amount of creditor protection, since a creditor holding the preferred interest must wait up to 20 years to collect. Accordingly, a creditor who acquires an interest in the Deferred LLC will be extremely motivated to settle its claim at a discount. Since a Deferred LLC can be formed in any state, families for whom asset protection is important should select a state that has very strong laws protecting LLCs and their owners.

<u>Conclusion</u>

The Deferred LLC can greatly enhance and diversify any family's existing estate plan. When properly structured and funded with growing investments, the Deferred LLC can achieve a wide variety of estate and business planning objectives. The ability of the Deferred LLC to defer required payments to its owners for at least 20 years distinguishes the Deferred LLC from all other popular estate planning techniques and puts it in a league of its own.

Alan Brown and Eric Mann are partners in the Private Wealth Services Group of the law firm Neal, Gerber & Eisenberg LLP in Chicago, Illinois.

Sage Hill Advisory & Management
18 Division Street
Suite 303B
Saratoga Springs, NY 12866
Main: 518-871-1214
www.sagehilladvisory.com