Planning with the

Wyoming Close LLC

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(Why it is the Entity of Choice)

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The Wyoming Close Limited Liability Company

The Close Limited Liability Company (LLC) was enacted by the Wyoming State Legislature in 2000. It augments the more general Wyoming Limited Liability Company statutes, providing greater restrictions on transfers of ownership interests, withdrawal or resignation from the LLC, and return of capital contributions and dissolution of the LLC. Where these statutes are silent or do not conflict with the general Wyoming LLC laws, such laws are also applicable to the Close LLC. The Wyoming Close LLC is the entity of choice for the following reasons:

- Ease of Administration
- Creditor Protection
- Maximization of Discounts
- Low Fees

Section 1.01 The History of the Limited Liability Company

A Limited Liability Company (LLC) is a hybrid of a corporation and a partnership in that it combines the most favorable characteristics of each. It allows the pass through of income, deductions and credits without the pass through of liability.

The first state to enact LLC legislation was the State of Wyoming in 1977. Thereafter, other states began allowing LLCs as a business entity, but LLCs were not favored as there was minimal case law governing this type of entity and because not all states had adopted LLC legislation. This created a concern that if an LLC were created in a jurisdiction statutorily allowed and it thereafter conducted business in a state not recognizing LLC status, a serious liability question could arise. The concern was that unless the laws of the state of organization of the LLC could be recognized as controlling, a creditor may be able to reach the assets of the entity owners (the members) of the LLC as if they were general partners in the nonrecognizing state. Thus even though LLCs have been in existence in state law for many years, the entity of choice for most estate planners remained the family limited partnership.

For estate planning purposes, LLCs were not generally used as it was believed they could not generate the discounting opportunities of a limited partnership. The rationale was that the underpinning of valuation theory did not apply to LLCs since they were unproven in case law and because state laws differed greatly or did not recognize LLCs at all.

At present, there is a growing body of LLC case law and all 50 states have enacted LLC legislation. The historical concerns regarding LLCs have thus been obviated. Additionally, there is now case law on LLC discounting and some states have amended their laws to maximize discounts. Thus LLCs have become one of the most exciting tools in the estate and business planning world. However, there is no uniform LLC law and each state's laws currently differ. It is important to study the various laws to determine which jurisdiction best meets your client's goals.

Section 1.02 The Characteristics of an LLC

The Basic Characteristics of an LLC are as follows:

It is a creature of state law and is created by the filing of Articles of Organization with the appropriate state entity. In Wyoming, this entity is the Secretary of State.

Members are the equity owners of the LLC. Most states require a minimum of two members, but several states allow a one person LLC. There is no limit to the number of members of an LLC and members may be individuals, trusts, corporations, general or limited partnerships, estates, or other LLCs.

Managers of the LLC are much like a board of directors of a corporation. They oversee the long-term goals and operations of the business as mandated by the LLCs members. The LLC may be member managed or manager managed. If manager managed, the manager need not be a member.

The entity may conduct almost any type of business unless specifically prohibited by state law.

The members and managers are protected from "personal liability" for the entity's debts and other obligations. The limit of an individual member's liability in an LLC is to the extent of his or her investment.

The LLC has an operating agreement similar to a partnership agreement that defines the terms upon which the entity will do business. This agreement must be agreed upon by all the members.

Section 1.03 The Main Reasons for Creating a Business Entity

There are many reasons for creating a business entity such as an LLC or limited partnership (LP), but the main ones are as follows:

The statutory protection from creditor claims is one of, if not the main reason in most cases, for creating a business entity. State law creates this protection from personal liability. However, this statutory protection from claims differs widely from state to state. If creditor protection is a concern for your client, it is vital for the advisor the research the best states for such protection. It is also wise to review the state's legislation for both limited partnership (LP) creditor protection as well as LLC creditor protection, as the laws of each state vary as to the protections provided for these two differing business entities.

Business entities are created to provide centralized management for diverse business entities. It is important to treat the entity as a business and manage it as a business should be managed.

Business entities are created to provide a structured environment for the sale or gifting of interests to others, generally family members. If the entity is created, an ownership interest in it may have a significantly different value from a proportionate value of the specific assets held within the entity itself.

Section 1.04 Why LLCs are Preferable Over Limited Partnerships

With the changes in LLC legislation, the authors believe that LLCs are almost always the preferred business entity over a limited partnership. There are two main reasons: 1) they are less complex and require less administration and 2) depending on the state, they are better for creditor protection.

(a) Ease of Administration

Limited partnerships require a general partner and a limited partner. Only the limited partner is statutorily afforded limited liability protection. The general partner is exposed to personal liability for claims of the partnership. If the general partner wants limited liability, it is necessary to wrap another business entity around the general partner. This entity is often a corporation, an irrevocable trust or an LLC. Because there are two distinct business entities, the following is required:

Two Tax Identification Numbers

Two Checking Accounts

Two Annual Tax Income Returns

Two Annual Reports to the State

Two Registered Agents

Because the LLC provides limited liability for all its members, whether they are managers and/or members, only one entity is required, thus making the administration of the entity much easier on the client and less likely for mistakes.

(b) Creditor Protection

In many instances as estate planners, we spend a great deal of time planning for families and reduction of taxes and other expenses. Our clients have worked hard for the assets they have, but often we do not spend much time on insulating, protecting and keeping their assets free from creditor claims. Some commentators have hinted that it may be malpractice not to counsel clients about asset protection options.

Business entities that are filed of record with the state are by statute given protection from creditors, as this recordation gives notice to the world that the entity is independent from the owners of the entity. Statutory entities include several different types of corporations, limited partnerships and limited liability companies. The entity must remain independent, with its own checking account, tax identification number and annual tax filings.

(1) The Limited Partnership Under RULPA

The Revised Uniform Limited Partnership Act (RULPA) was enacted in 1976 and amended in 1985. Historically its Section 703, *Rights of a Creditor*, was interpreted to read that a charging order was the only remedy allowed a Court to give a creditor of a partner in a partnership. Section 703 in pertinent part reads as follows:

> *On application to a court of competent jurisdiction by any judgment creditor of a partner, the court* <u>*MAY*</u> *charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest*. (Emphasis added)

Charging Orders are unattractive remedies for a creditor as the creditor stands in the shoes of an assignee and will not receive anything from the partnership unless distributions are made to the debtor partner. One position is that the creditor issued a charging order may not receive any distributions but may be required to pay the taxes on undistributed profits of the partnership upon receipt of a K-1, putting the creditor in the position of possibly throwing good money after bad.

However, the view that a charging order is the sole remedy under this Section 703 is subject to attack because of the word "may" in the statute. All but a few states fail to specifically limit the remedy to a charging order. Thus the argument can be made that in addition to a charging order, a creditor can ask and a court can order a foreclosure of the interest subject to the charging order. The foreclosure is different from the charging order in that it is permanent, and that a purchaser at a foreclosure sale enjoys the right to a proportionate share of the partnership's assets upon dissolution—increasing the creditor's chances of having the debt satisfied out of the partnership interest.

(2) The Limited Partnership Act under ULPA

Section 703 of the 1976 Act is currently subject to amendment by Section 703 of the Uniform Limited Partnership Act of 2001. This Section is even more creditor friendly, in that it specifically allows a creditor to foreclose. This Section in pertinent part reads as follows:

> On application to a court of competent jurisdiction by any judgment creditor of a partner or transferee, the court may charge the transferable interest of the judgment debtor with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of a transferee. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect of the partnership and make all other orders, directions, accounts and inquiries the judgment debtor might have made or which the circumstances of the case may require to give effect to the charging order.
>
> A charging order constitutes a lien on the judgment debtor's transferable interest. The court may order a foreclosure upon the interest subject to the charging order at any time. The purchaser at the foreclosure sale has the rights of a transferee.

(3) Limited Partnership Statutes That Are Creditor Unfriendly

A few states have enacted legislation modifying Section 703 to make it unfriendly to creditors. Those states have legislation specifically stating that a charging order is the sole remedy available to a creditor. There are very few states in the nation that have good creditor protection legislation for partners of a limited partnership.

Section 1.05 Creditor Protection for LLCs

The Wyoming Close LLC is silent as to the rights of a creditor to attack a member's interest in the LLC, and thus one must look to the general Wyoming LLC statute, found in WS § 17-15-145. It reads as follows:

> **Rights of Creditor**
>
> On application to a court of competent jurisdiction by a judgment creditor of a member of a limited liability company or a member's transferee, the court may charge the member's distributional interest in the limited liability company with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of a transferee of the member's interest as provided in WS § 17-15-122. The charging order is the exclusive remedy by which a judgment creditor of the member or transferee may satisfy a judgment against the member's interest in a limited liability company. This section does not deprive any member of a limited liability company of the benefit of any exemption laws applicable to the member's interest.

This requirement is the most restrictive and "creditor unfriendly" as it denies a creditor any remedy other than to acquire a charging order and allows a creditor to have distributions only if the manager of the LLC decides to make any distributions. It cannot disrupt the ongoing business of the LLC. This restrictive statute makes Wyoming a good choice for LLC planning.

The other states across the country vary in the rights of a creditor to attack the LLC and disrupt its ability to run the business. By way of example, two statutes that are extremely creditor friendly are California and Colorado. In California, a judicial foreclosure sale of a membership interest is allowed by statute. In Colorado, upon application of a judgment creditor, the court 1) may charge the membership interest, 2) may appoint a receiver, and 3) may make all other orders, directions, accounts and inquiries the debtor member might have made, or 4) other orders which the circumstances of the case require. These statutes are a litigation attorney's dream and can keep the LLC in the court system for years to come because of a debt of one of the members.

Section 1.06 Valuation Adjustments and Applicable Restrictions

Business entities are often used in conjunction with estate planning as they can assist in gift and or estate tax reduction. Typically, when a client transfers assets to a business entity such as an LLC, he or she exchanges those assets for membership units in the LLC. Having made the exchange, the client no longer owns the various assets but only the value of the units inside the LLC. Often, the value of an ownership interest in a business entity may be significantly different from a proportionate value of the specific assets held by the business entity. According to IRS regulations, fair market value is the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts".

It is well established in case law that in determining the fair market value of an interest in a closely held business, the value will be adjusted to reflect various discounts such a discount for lack of marketability, a discount for lack of control, a discount for a minority interest and a discount for fractionalized interests. These discounts can result in a very favorable valuation adjustment for estate and gift tax purposes.

In addition to an analysis of the assets of the LLC and the interests of the members, the operating agreement between the members of the LLC is scrutinized by a business appraiser to determine exactly what the valuation adjustment or discount should be. The appraiser reviews many issues, including what members have control, a member's ability to withdraw from the LLC, and the ability of members to dissolve the LLC. The greater these restrictions, the greater the decrease in a member's value of the units becomes.

However, Congress has placed some requirements on restrictions in operating agreements. In the Omnibus Budget Reconciliation Act of 1990 (OBRA 1990), it enacted a series of special valuation rules applicable to transfers of interests in corporations, partnerships, trusts and limited liability companies. One of these provisions, Section 2704(b), provides in pertinent part:

> Sec. 2704(b). Certain Restrictions on Liquidation Disregarded.-
>
> (1) In general.-For purposes of this subtitle, if-
>
> > (A) There is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and
> >
> > (B) The transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, *any applicable restriction shall be disregarded in determining the value of the transferred interest.*
>
> (2) Applicable restriction. –For purposes of this subsection, the term "applicable restriction" means any restriction-
>
> > (A) Which effectively limits the ability of the corporation or partnership to liquidate; and
> >
> > (B) With respect to which either of the following applies:
> >
> > > (i) The restriction lapses, in whole or in part, after the transfer referred to in paragraph (1).
> > >
> > > (ii) The transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.
>
> (3) Exceptions. The term "applicable restriction" shall not include-

(B) any restriction imposed, or required to be imposed, by any Federal or State law.

Section 25.2704(b), Gift Tax Regs., provides that an applicable restriction is a restriction on "the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction".

These restrictions only apply in transfers to family members, as defined in the Code and accompanying Regulations. Thus where a transferor and his/her family control a business entity, a restriction on the right to liquidate the entity shall be disregarded in determining the value of an interest that has been transferred to a family member if, after the transfer, the restriction on the liquidation either lapses or can be removed by the family. Because withdrawal restrictions in an operating agreement can have the effect of liquidating the entity, it is important to scrutinize the operating agreement regarding a member's right to both liquidate the LLC and to withdraw from the LLC.

An applicable restriction is "a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction". (Section 25.2407-2(b), Gift Tax Regs.). Thus it is very important to analyze the state law governing the entity to determine how restrictive that law is, because it is that state law that must be applied when determining the discount, regardless of how restrictive liquidation rights or withdrawal rights are defined in the operating agreement.

The Wyoming Close LLC provides the following for liquidation and dissolution rights:

WS §17-25-107, Withdrawal of Members and Return of Member's Contributions to Capital

(a) A member may only withdraw from a closed limited liability company upon the terms and conditions set forth in the operating agreement. If no terms and conditions for withdrawal of a member are set forth in the company's operating agreement, a member may withdraw only with the consent of all other members of the company.

(b) A member shall not receive out close limited liability company property any part of his or its contribution to capitol unless:

(i) All liabilities of the company, except liabilities to members on account of their contributions to capitol, have been paid or there remains property of the company sufficient to pay them; and

(ii) All members consent to such return of contributions to capitol;

(iii) The company is dissolved; or

(iv) The articles of organization or operating agreement of the company otherwise provide for the return of contributions to capitol.

(c) In the absence of a statement in the articles of organization to the contrary or the consent of all members of the close limited liability company, a member, irrespective of the nature of his or its contribution, has only the right to demand and receive cash in return for his or its contribution to capitol.

(d) A member of a close limited liability company may not have the company dissolved for a failure to return his or its contribution to capitol.

WS §17-25-108, Dissolution

(a) A close limited liability company organized under this chapter shall be dissolved upon the occurrence of any of the following events:

(i) When the period fixed for the duration of the company expires;

(ii) By the unanimous written agreement of all members; or

(iii) At the time or upon the occurrence of events specified in the operating agreement.

(b) As soon as possible following the occurrence of any of the events specified in subsection (a) of this section causing the dissolution of a close limited liability company, the company shall execute a statement of intent to dissolve in the form prescribed by the secretary of state.

Because the Wyoming Close LLC requires unanimous consent of all members for withdrawal, dissolution and a return of capital, it has the most restrictive standards, and therefore the "applicable restrictions" mandated in IRC 2704(b) do not apply. Thus maximized discounts are available for valuation purposes.

When choosing jurisdictions, it is vital that each statute for creditor protection, withdrawal and dissolution be analyzed. For example, the Arizona LLC statute for creditor protection is very good, (charging order is the exclusive remedy) but its LLC statutes allow a member to withdraw at any time and allow a dissolution to occur upon the written consent of more than one-half of it members or one (or more members) entitled to more than one-half of the assets. Thus, if an Arizona LLC operating agreement has liquidation or withdrawal requirements more restrictive than the Arizona law, the applicable restriction rule of 2704 would apply, and the state law rather than the operating agreement would control for discounting of the assets.

Many states in the country are similar to the Arizona statutes, allowing member withdrawal within a certain period of time (i.e.: 30 days or six months) and dissolution upon majority vote or another percentage, less than unanimous. There are only a few states that require one hundred percent consent of all members for these actions. In addition, some states allow for a return of LLC assets upon withdrawal, rather than cash. This return of assets can further disrupt the business of the LLC and could even force a dissolution.

Section 1.07 Low Fees

The Wyoming fee schedule for LLCs WS § 17-15-132 is very competitive with other jurisdictions. The fee for filing the LLC with the Secretary of State is $100. Thereafter, the LLC pays an annual fee of the greater of $50.00 or two-tenths of one mill on the dollar (0.0002), if its capitol, property and assets reported, whichever is greater.

However, that fee is only charged on the capitol, property and assets within the State of Wyoming, and not on LLC assets outside of the state. Thus the great majority of LLCs in Wyoming merely pay the minimal fee of $50 annually.