ENTITY AND LLC OPERATING AGREEMENT PLANNING TIPS

CURRENT ACTIONABLE PLANNING IDEAS

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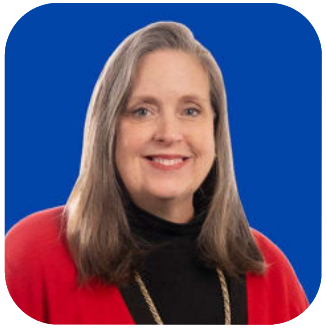

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Entity and LLC Operating Agreement Planning Tips

PRACTICAL IDEAS THAT MAY ENHANCE PLANNING

Master Governing Document For Client With Scores Of Entities

- Some clients have a tremendous number of entities. For example, a real estate developer would be advised to set up a separate LLC for each deal/property. But that might result in dozens, even scores of entities. How can documentation be created for governing this many entities without the cost and complexity of a separate document for each LLC? An answer might be to create a single master or aggregate operating agreement for all entities and have each entity sign one agreement. That would greatly reduce the paperwork and costs of a transfer where you might need to only amend and restate one agreement for each phase of the transaction rather than scores of documents.
- Master Operating Agreement Selected Provisions
- WHEREAS, the intent of this Operating Agreement is to provide a "master" or umbrella operating agreement which the real estate entities owned primarily by a member of the Client-Name family, and trusts for such family members, can be bound to simplify the administration of all such real property limited liability companies, provide uniformity of the governing provisions and documentation for such entities, and thereby reduce legal and administrative costs and complexity.
- WHEREAS, it is the express intent of each Party hereto that this Operating Agreement, in conjunction with any joinder or adoption agreement, be equivalent to a separate operating agreement signed by each individual Company, the members of that Company, and the Manager of each Company. By way of example and not limitation, each Party hereto covenants and agrees to execute any further documentation, such as a variation of this Operating Agreement reflecting only information pertinent to that particular Company, its members and the Manager and redacting any information pertinent to any other Company and their Managers.
- WHEREAS, any reference to a "Member" or "Membership Interest" or any other term relevant to any member, Company, etc. shall only refer to a Member or Membership Interest or any other such term in a particular Company and in no manner shall provide any Member or Membership Interest in any one Company any rights or obligations in any other Company.

Savings Language For Governing Documents Whose Interests May Be Transferred Subject to Defined Valuation Mechanism

- Trust companies and CPAs may inadvertently overlook Wandry adjustment language and incorrectly list a specific number of shares or percentage of membership interests as an asset of a trust or on a K-1. Consider adding savings language to the entity governing documents as a fallback argument. While there is no assurance that this will work consider:

- **Membership Interest or Interest:** A Member's Percentage Interest, right to distributions under this Agreement, and any other rights which such Member has in the Company, subject to such Member's obligations to the Company as provided herein or under the Act. Membership interests may be transferred based on fixed dollar formulas such as the approach used in Wandry v. Commissioner, T.C. Memo. 2012-88. IRS non-acquiescence: Action on Decision (AOD) 2012-04, published in IRB 2012-46 (November 13, 2012), or other defined value mechanism approaches. In such event the listing of a percentage membership interest in this Agreement or in any other application when in fact that interest is not at that time a known percentage interest but rather a dollar value subject to a valuation adjustment mechanism shall expressly not change the legal right from being a dollar interest to being a percentage interest until such time as such change shall become confirmed and certain under the terms of the defined valuation mechanism governing that interest.
- Remember under the Sorrenson case if the formalities of the valuation adjustment are ignored they may be disregarded.

FLP/LLC interests may avoid estate inclusion under a Powell challenge

- Removing all interests from the client's estate may not suffice.
- In the Powell case FLP assets were included in decedent's estate under Code Sec.2036(a)(2) even though the taxpayer only owned LP interests (i.e., the taxpayer did not own any GP interests that would have clearly provided him control). The decedent, the Court reasoned, retained right in conjunction with other person to designate who could enjoy the property or its income under Code Sec. 2036. Also, under Code Sec. 2038 the taxpayer/decedent had retained the power to alter, amend, revoke, or terminate the transfer. The court reasoned that the decedent as owner of 99% of the FLP interests "in conjunction with" all the other partners could dissolve the partnership at any time. Even though some argue that Powell was a bad fact case many practitioners are concerned to try to avoid its reach by having the decedent divested of any rights to control distributions from the entity, liquidation of the entity, or the right to change the provisions of the governing instrument that pertain to those two rights.
- Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017) June, 2017.

There Are Various Approaches To Endeavor To Negate A Powell Argument

- Not addressing the issue.
  - This non-approach might be used for client LLCs where that level of planning is too complex or costly and/or when an active business interest is involved. This approach is not necessarily without thought or merit as some commentators view the Powell/Moore cases as a bad fact case that should not necessarily apply in all other situations, and certainly not if there is an actual operating business.
- Special Voting Membership Interests.
  - One approach is to create a special voting membership interest and have the taxpayer/transferor divest him or herself of all those interests. A common way that is implemented is recapitalizing the entities involved creating a special voting membership interest that controls liquidation, distributions, and amending that provision so of the governing documents. Then, the taxpayer/transferor would sell (not gift) that special voting membership interest to a trust in which the taxpayer/transferor has no interests or control.
  - The goal of this approach is for the company to segregate specific powers and voting rights governing decisions as to distributions, dissolution and amending provisions governing those matters in its operating agreement in and as a voting membership interest as provided for in the operating agreement.
- Authorized Member Voting Rights.
  - Carve out voting rights in the operating agreement. For a multi-member LLC, a definition of "Authorized Members" could be provided to endeavor to address the Powell Issue as an alternative. It could be designated in the operating agreement that only the Authorized Member may vote on liquidation, distribution or changing those provisions in the operating agreement. Effectively other named persons who are not subordinate to the taxpayer would be the special voting members.

There Are Various Approaches To Endeavor To Negate A Powell Argument

- Sell Entity Interests to Irrevocable Trust.
  - The client may sell all ownership interests in the entity to an irrevocable trust. If this is done the taxpayer should not be the investment advisor of the new trust and in fact the trust document should preclude her from serving in that role.
- Independent Trust Protector Consent.
  - You could require that the operating agreements governing the entity, for trust members to have consent of an independent trust protector for distributions and liquidations. Since the taxpayer is commonly named as the investment trustee or investment advisor and the trust protector is (or must be in this approach) independent, this may be a viable approach although there is no law on this (or most aspects of the planning discussed in this letter). The trust protector would have to approve any modification of the operating agreement as to distribution or liquidation requirements or to make a distribution or liquidation from the LLC.
- Business Judgement Rule.
  - Some believe that drafting governing documents to include a business judgment rule/requirement may suffice to deflect the Powell issue. This concept is that if the persons holding distribution and liquidation rights have to exercise the powers that for example a manager in an arm's length arrangement with unrelated parties would have to exercise that there could be no inappropriately retained rights to cause estate inclusion.

Other Clever LLC Drafting Considerations from Alan Gassman, Esq.

- If a transfer into the LLC would cause a 721(b) tax it goes to a separate compartment of the LLC and is not "mixed into avoid the diversification that could trigger gain.
- If an LLC interest is gifted to a Crummy Trust the transferability restriction could be abated if the Trust is for relatives of the majority or voting control owner to perhaps make the Crummey Power viable and the interest in fact a "present interest."
- Possible transfer on death provisions so that probate may be avoided upon death under the Florida case law on this.
- Consider making the LLC operating agreement an executory contract so that charging order protection will hold up n bankruptcy.
- Safety clause to avoid violation of 2nd class of stock rules for S corporations and LLCs taxed as S corporations.
- Safety clause to avoid loss of tenants by the entirety ("TBE") status by breaking the 6 unities by accident.

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