

SANDWICH GENERATION



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**UNL Extension
North Central Extension Risk Management Education**

Need For Personal Legal Advice

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PART I A Little Background



A Partial Decision Tree

- What is your estate? What is the value?
- Who are your heirs?
- Are you still operating a business?
- Is there a successor?
- Who will receive what? Dispositive wishes
- How will they own it?
 - Separate inheritances
 - Co-ownership
 - Indirect Ownership

Direct & Indirect

- Direct Ownership
 - Heirs own property in their own names as individuals
 - Separate or undivided?
- Indirect ownership
 - Owning property in an entity or in trust
 - Entity owns/holds property; individuals own entity

Direct

- Direct ownership - as individuals
 - Separate: to each her own – simplest plan
 - Not responsible to each other for property
 - Not in business together
 - Together: co-ownership
 - tenancy-in-common
 - joint tenancy
 - No management structure;
 - Subject to right of partition
 - Subject to each owner's creditors

Indirect

- Indirect ownership – why use it?
 - Management structure
 - Asset protection
 - Separate ownership and management
 - Provide a buy-sell arrangement
 - Keep ranch in family
 - Ease of transfers
 - Some tax planning
 - Avoid partition right

PART II Terms To Know



Terms to Know

- Closely Held
- Limited Liability
- Flow Through Taxation
- Double Taxation
- Asset Protection
- Transfer restrictions

**Terms to Know
“Closely Held”**

- Ownership is restricted
 - Interests or shares not freely transferable
- Often owned only by family members
 - Governing documents spell it out
- Typically, no market exists for ownership interests

**Terms to Know
“Limited Liability”**

- Various kinds
 - Ford Motor Co. stock - no liability for owner
- Owners of business can manage business but not be personally liable for business debts, risks, etc.
 - Trucking example
 - Everyone remains liable for own negligence
- Sole proprietors and general partners are liable for all debts, etc.
 - Limited partners not liable but cannot manage

**Terms to Know
“Flow Through Taxation”**

- Entities taxed as partnerships do not pay income tax, the owners pay it
 - no entity-level taxation
- Business profits (and losses) are taxed on owner’s returns
 - K-1
- Unlike a “C” corporation: double taxation
 - Both Corp and shareholder/owner pay tax

Terms to Know
“Flow Through Taxation”

- Mom and Dad each own 35% of the LLC and three kids each own 10%
 - Mom and Dad will be allocated 35% of the net income from the LLC and the kids 10%
- Each will receive a K-1 at end of year showing their allocation
 - must include that amount in their individual 1040s
- This is true whether or not any of them receives actual cash equal to the allocation: opportunity for oppression

Terms to Know
“Double Taxation”

- Land worth \$50,000 put into C Corp
- Landowner receives stock with basis = \$50,000
- Time passes, land now worth \$100,000
- Corp sells land or liquidates
- Corp pays tax on \$50,000 capital gain
 - $\$50,000 \times .15 = \$7,500$
- Individual receives cash from corp = \$92,500 (\$100,000 sale price less \$7,500 tax)
- Individual pays tax on capital gain:
 - $\$92,500 - \$50,000 \text{ (basis)} = \$42,500$
 - $\$42,500 \times .20 = \$8,500$
- Total Federal Tax = \$16,000

Terms to Know
“Double Taxation”

- If land had been owned by individual or by flow-through entity, tax would be less
 - Because no double taxation
- \$100,000 sale price – \$50,000 basis = \$50,000 of capital gain
- $\$50,000 \times .20 = \$10,000$
- Total Federal tax - \$10,000

**Terms To Know
“Asset Protection”**

If Mom & Dad give land, livestock or machinery to an heir, then in general:

- heir is free to sell or mortgage that property
- property is owned by heir and so subject to heir’s creditors and liabilities
- If property not kept separate from other assets, may become marital property
 - subject to divorce property settlement
 - subject to spousal elective share at death

**Terms To Know
“Asset Protection”**

If Mom & Dad give interests in entity to an heir, then in general:

- Heir’s creditors have no direct access to those interests
- Easier to keep interests separate from marital property
 - If heir works for entity, increase in value of interests after gift is made may become marital property
- Restrictions can be imposed on transferring interests: keep it in family

**Terms To Know
“Transfer Restrictions”**

- Restrict who can be an owner
 - Lineal descendants only?
- Define when and how ownership interests/shares can be transferred
- Provide options or preemptive rights
 - Direct ownership toward the actively engaged, or those with strongest ties to ranch
- Provide buy-sell provisions/agreement

PART III
Entity Elements



Entity Questions

- What is purpose of entity?
- Who will own the entity?
- What will the entity own?
- When will assets be put into the entity?
 - What is each owner contributing?
- What will entity do with the assets?
- Do all owners get to vote?
- Who will manage the entity?

Ownership Questions

- Who can be an owner in the entity?
 - Lineal descendants only
 - Adopted children?
 - Spouses?
 - allow for spousal income interests through trusts?
 - Other parties but only with consent of other owners
 - Unanimous or majority

Management Questions

- Who will manage/control?
 - All owners together?
 - Only certain people?
 - Through voting rights/management interests
 - Through majority ownership
 - Through trust that holds management rights
 - Do some decisions require vote of all owners?
 - Selling land
 - Incurring large debt
 - Decisions outside ordinary course of business

Management Questions

- Who will manage/control?
 - Does manager have to be an owner/member?
 - Management succession
 - What happens if a manager retires or dies?
 - How is successor chosen?
 - Does manager have ability to choose successor?
 - Do owners/members vote on manager?

Transfer Restrictions

- What happens when an owner wants out, dies, or runs into financial trouble?
 - Governed by buy-sell provisions or by statute
 - Preparing buy-sell provisions is good exercise in contemplating the future, in planning
 - Is buy-sell a separate agreement or part of entity by-laws, operating agreement, etc?

Transfer Restrictions Buy-Sell

- When an owner wants out:
 - Buy-sell may create a market for interests
 - Questions:
 - Does company have to buy? (Typically, no.)
 - Do other owners have to buy? (Typically, no.)
 - What is the price – as negotiated, or appraised, or tax assessed? Is it discounted?
 - Lump sum or over time?
 - How many owners can sell at one time?
 - Protect viability, e.g. only one sale every 5 years

Transfer Restrictions Buy-Sell

- When an owner dies:
 - Can he/she leave interests in entity to eligible owners as a right?
 - Or does death trigger buy-sell provisions
 - Surviving owners get a chance to buy
 - May direct ownership into fewer owners over time
 - Questions:
 - Do company or other owners have to buy?
 - What is the price?
 - Lump sum or over time?

Transfer Restrictions Buy-Sell

- When an owner is in financial trouble:
 - Part of asset protection
 - Restricting ownership – only family members
 - Triggers a buy-sell
 - Limits creditor's rights
 - Often creditor only entitled to distributions of profits, if any
 - No membership; no voting rights
 - Protects the ranch

Transfer Restrictions

- Restricting transfers is a balancing act:
- On the one hand:
 - Keep business in the family
 - Allow managers freedom to operate without interference from non-active members
 - Protect assets from members' problems
- On the other:
 - Create income stream for all members
 - Create value/equity participation for all members
 - Prevent majority from being unfair to minority: keep it out of court

Asset Protection

- Three kinds
 - Protect members' assets from the entity liabilities (limited liability)
 - Protect entity assets from owners' debts, obligations and liabilities
 - Protect entity asset/the family ranch from conflicts among members

Asset Protection

- Build in good transfer restrictions
 - Limiting ownership
- Use enforceable buy-sell agreement
- Rely on existing laws
 - Charging orders for creditor of LLC member

Asset Protection x Two: Entity Owned By A Trust

- Mom & Dad set up entity
- Entity is owned by a trust
 - Mom & Dad are Trustees of the trust
 - Mom & Dad are beneficiaries
- After death of Mom & Dad, children become the beneficiaries
- Trust names a successor trustee (perhaps the On-Ranch Heir) to manage the trust (and so the entity, which is owned by the trust)
- Trust is spendthrift so kids' creditors cannot reach its assets, that is, the entity (which owns ranch)

Preventing Oppression

- Imagine majority members in control of LLC
 - Pay high salaries for management
 - Invest all of profit in new machinery or new land purchases
 - Other members receive next to nothing for their ownership interests: no sharing in profits
 - In corporate law, called "dividend squeeze"
- What do minority owners do? Try to sell interests or go to court and argue oppression!

Preventing Oppression

- Require consent by majority of owners for certain decisions
 - E.g purchase of land, expenditures/debt over certain amount
- Require disclosure of books
 - Transparency
- In flow-through entity, require distributions sufficient at least to cover taxes on allocations of profits
- Have a good buy-sell agreement

Duration

- How long does entity last?
 - Stated number of years
 - Pegged to lives of heirs
 - Perpetual existence
- If perpetual, provide mechanism for termination
 - Manager's decision?
 - Percentage vote of owners?

Options

- Should successor have right to buy out the others?
 - More than a buy-sell: options
 - Gives certain owners the right to buy out other owners
 - A tool for succession
 - What is price and how paid?
 - FMV or discounted?
 - Lump sum or over time?

PART IV Entities



ENTITIES

- Tax considerations play a big role in choosing which entity to use
 - Income tax
 - Basis issues
 - Self-employment taxes
 - Medicare and NIIT taxes
- Limited liability entities are restricted to single payment limitation under FSA rules

ENTITIES

- A trust is not commonly a business entity
 - Separate management from enjoyment
 - Best asset protection
 - Less flexibility in general and for taxes
 - Difficult to retain control while also transferring ownership
 - Tax planning tool

There Are Several Options

- General partnership
- Limited partnership
- Limited liability company
- Corporations
 - C corps
 - S corps
- Family limited partnerships
- Trusts

LLC is preferred because...

- Flow-through taxation with limited liability even for managers and more flexible than S Corp
 - Sec. 754 election for inside basis
 - Generally, no gain on asset distribution
 - LLC allows special allocations
 - Fewer restrictions on ownership
 - Potentially better state-law asset protection
 - Easier member loan transactions
 - Easier to sell (can sell assets)
 - Easier to set up and run

Basic LLC Features

- Limited liability for owners/managers
- Flow through taxation
- Flexible management/ownership structure
- Transfer Restrictions
- Asset Protection
- Ease & Expense
- Perpetual Life

LLC:

Creature of Statute/Creature of Contract

- Statute: The Nebraska Uniform Limited Liability Company Act (Nebraska Revised Statutes §§ 21-101 to 21-197)
- Statute is default – applies only where needed – otherwise the **operating agreement** controls – the contract
- Wide freedom to decide how to run LLC in the operating agreement
- But, if no operating agreement, the statute governs the LLC

LLC Operating Agreement

- Establish percentage ownership for each member
 - Capital account
- Establish each member's share of profits (or losses)
 - Profits account
- Define the management structure: decision making
- Determine voting power
- Provide for management succession
- Provide for departure and addition of members
- Define business purpose
- Provide rules for meetings and taking votes
- Provide for ownership transitions: buy outs, buy-sell agreements, membership eligibility, puts & calls

Ease & Expense

- No restrictions on number or type of owners
- Tax free formation
- Tax free contributions
 - Can transfer appreciated property to entity without recognizing taxable income
- Tax-free withdrawals
 - No double taxation
- Can transfer interest but retain control

Perpetual Life

- LLC can have perpetual existence or a term of years
- LLC under default statutory rules presumed to be perpetual
- Has no effect on the tax treatment of the LLC
- Perpetual existence nominally attractive to parents who wish to see farm preserved through time
 - The trick of course if to make it viable as it goes
