

# SANDWICH GENERATION



Prepared by: Joe M. Hawbaker, Hawbaker Law Office, Omaha

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

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## Need For Personal Legal Advice

The information in this presentation and accompanying material is provided for educational purposes only. It is not a substitute for individual legal consultation.



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## **PART I** A Little Background



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## 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

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## 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

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## 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

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## 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

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## PART II Terms To Know



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## Terms to Know

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

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**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

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**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

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**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

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**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

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**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

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**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

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**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

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**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

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**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

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**PART III**  
**Entity Elements**



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**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?

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**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

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## 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

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## 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?

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## 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?

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## 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

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## 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?

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## 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

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## 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

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## 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

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## 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

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### **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)

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### **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!

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### **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

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## 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?

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## 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?

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## PART IV Entities



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## 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

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## 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

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## There Are Several Options

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

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## 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

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## Basic LLC Features

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

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## 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

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## 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

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## 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

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## 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

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