

# **Desirable Characteristics for the Business Entity**

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- Maintain control while giving interests to family members (unity of management)
  - Avoiding veto power of small owners
- Preventing interests in family property from passing to outsiders as a result of death, divorce or other disposition
- Limited liability
- Creditor/asset protection
- Limited withdrawal rights
- No taxation at the entity level
- Discounted values for entity interests

# **Desirable Characteristics for the Business Entity**

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- Facilitating gifts
- Qualification for special tax provisions
- Perpetual life
- Avoids the difficulties with fractional interests
- Avoids ancillary probate
- Can be used to reduce estate taxes
- Provides a succession plan
- Economies of scale
  - Access to investment managers
  - Possibly negotiating reduced fees
  - Providing accounting and fund management

# **Transfer Taxation of Interests in Partnerships**

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- Transfers are frequently valued at a discount
  - The value of the interest is the price at which the interest 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

# Transfer Taxation of Interests in Partnerships

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- Discounts
  - Lack of control
    - Little voice in partnership operations
    - Cannot obtain pro rata share by compelling liquidation
    - Cannot obtain the value of his interest by redeeming it
    - Cannot transfer his management rights
    - Cannot compel distributions
    - Must pay taxes on his allocable share
  - Lack of marketability
    - Few unrelated parties would be interested in a minority interest in a family partnership without a substantial discount
- Discounts are typically 25 to 35%

# **Business Entities in Alabama**

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- Single Owner
- Multiple Owners

# **Business Entities in Alabama**

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- Single Owner
  - Sole proprietorship
  - Limited liability company
  - Corporation, S or C
- Multiple Owners
  - General partnership
  - Limited partnership
  - Registered limited liability partnership
  - Limited liability company
  - Corporation, S or C

# Liability of Owners

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GP/RLLP	LP	LLC	Corp.
<p>All partners are liable jointly and severally for all obligations of the partnership</p> <p>A partner in an RLLP is not personally liable</p>	<p>General partners are jointly and severally liable for the debts of the LP</p> <p>Limited partners are not personally liable</p>	<p>Members are not liable for obligations of the LLC for acts or omissions of any other member</p> <p>A member may become liable because of his own conduct.</p>	<p>A shareholder is not personally liable for the acts or debts of the corporation (except amount contributed)</p> <p>“Piercing the corporate veil”</p>

# Participation in Management

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GP/RLLP	LP	LLC	Corp.
Partners have a statutory right to participate in management	General partners participate in management but Limited partners are prohibited from participating in management	Members or managers may participate in management as provided in the articles of organization	Shareholders participate in management by electing directors to determine policy and appoint officers



# Transferability of Interest

GP/RLLP	LP	LLC	Corp.
<p>A partner's or member's interest is transferable, but the assignee only gets the income interest.</p> <p>Unless provided otherwise the assignee only becomes a partner/member with the unanimous consent of the other partners/ members.</p> <p>The partnership/operating agreement can limit a partner/member's right to withdraw or assign his interest.</p>			<p>Shares are freely transferable, subject to restrictions in the organizational documents</p>

# Classification for Tax Purposes

GP/RLLP	LP	LLC	Corp.
<p>Generally taxed as a partnership which means “flow through” taxation (entity files an information return, but the owners pay the tax on their individual returns.)</p> <p>Income is from self-employment so FICA rate = 15.3%, except for limited partners or members who are not managers.</p> <p>Entity can elect to be taxed as a corporation.</p>			<p>A C-corp. is subject to double taxation</p> <p>An S-corp. is taxed similar to a partnership</p>

# Allocation of Profits and Losses

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GP/RLLP	LLC	LP	Corp.
<p>Per capita (regardless of contribution), unless modified by the partnership agreement.</p> <p>In general, may be allocated in any manner the partners agree so long as the allocation is in accordance with the partners' interests or otherwise has substantial economic effect.</p>		<p>Pro rata to contributions (unless modified by the partnership agreement)</p>	<p>Profits – pro rata to number of shares, (plus salary)</p> <p>C-corp. – only profits are passed to s/h</p> <p>S-corp. – profits and losses are allocated to s/h</p>

# Creditor Rights

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GP/RLLP	LP	LLC	Corp.
<p>A creditor can get a charging order.</p> <p>A creditor may get a judicial winding up</p>			<p>C-corp.: creditor can seize stock</p> <p>S-corp.: creditor can seize stock</p>

## **Family Limited Partnerships or Limited Liability Companies**

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- 100% control regardless of ownership percentage (2% is the lower limit)
- Creditor protection
- Limited withdrawal rights
- No taxation at entity level
- Succession plan
- Can be used to reduce estate taxes
- Can be used to avoid ancillary probate
- Perpetual life

# **Family Limited Partnership or Limited Liability Company**

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- FLP

- General partner has unlimited liability
- Have to pay withdrawing partner

- LLC

- Unlimited liability for all members
- Don't have to pay withdrawing member

# **Disadvantages**

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- Expense of forming the business entity
- Privilege tax – minimum of \$100/year up to \$500/year for a family business
- Separate tax return (Form 1065)

# Forming the Business

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- FLP

- File Certificate of Limited Partnership with the Probate Judge
- Develop the partnership agreement

- LLC

- File Articles of Organization with the Probate Judge
- Develop the operating agreement