

MEMORANDUM

TO: Barber Emerson, L.C. / Family Limited Liability Company Clients
FROM: Barber Emerson, L.C.
DATE: July 28, 2003
REGARDING: Operational Issues for Family Limited Liability Companies

INTRODUCTION

This memorandum addresses some of the basic operational issues to which one should adhere in order to realize the full benefit of a Family Limited Liability Company (the "FLLC"). Although FLLC's are usually established to achieve both tax planning and family business objectives, the family business objectives are perhaps more significant than the tax planning objectives. Some of the more important family business planning objectives are the following:

A. The gift of an interest in the FLLC, rather than a gift of cash or securities, involves the gift of an asset that the donee cannot spend or otherwise dispose of without the donor's consent. The donor must consent because the donor, either individually or through his or her family, controls the assets of the FLLC.

B. Consolidation of family assets into a FLLC may create significant operational cost savings, and advantages may be significant both for real estate interests transferred to the company as well as marketable securities.

C. The use of FLLC's may simplify annual giving because interests in those entities can be the subject of annual gifts, rather than undivided interests in specific property.

D. Use of FLLC's may provide some protection of family assets from creditors.

E. FLLC's may provide some asset protection against children's or grandchildren's failed marriages.

F. FLLC's may, through a properly drafted agreement, institutionalize family communications on family business and financial matters, and may permit family members to participate in the management of family assets, without the senior generation losing control.

G. FLLC's are generally controlled by majority vote, although certain matters may require a super majority. Because at least a majority vote is generally required for any action, including the sale of real estate owned by the FLLC, the right of one child to force a partition of family real estate following the parents' deaths is prevented.

H. FLLC's may be structured to ensure that the company's assets will stay in the family by requiring any attempt to assign an interest in the company to a person outside the family to be subject to buy-sell options given to the other family members.

I. FLLC's, through their operating agreements, provide that disputes with regard to ownership or distribution of property be settled by arbitration rather than litigation. Arbitration of family property disputes does not involve the publicity, and often the acrimony, that may develop through litigation.

J. FLLC's may simplify the disposition of real estate investments, including vacation property, located outside one's home state. Contributing that property to a FLLC avoids the cost that might be incurred in probate procedures in another state.

In order to achieve these business objectives, while preserving limited liability to the members of the FLLC, FLLC's must be operated as separate and distinct entities. In other words, the separate legal identity of the FLLC must be established apart from the owners' personal identity. If, during the operation of the FLLC, the members fail to maintain the separate entity status of the FLLC, the IRS may successfully argue that the FLLC is nothing more than the senior members' "personal pocketbook". If the IRS is successful in arguing that the FLLC is nothing more than a senior family member's "personal pocketbook", the significant gift and estate tax benefits of the FLLC will no longer exist. Moreover, failure to preserve FLLC status may expose FLLC members to joint and several liability for FLLC liabilities.

DISCUSSION

In order to preserve the estate tax and gift tax opportunities which are present in FLLC's, as well as limited liability for the members, an FLLC must be operated in a manner that accomplishes a business or investment purpose and respects FLLC's separate existence. We suggest, therefore, that a FLLC be operated according to the following guidelines.

A. The services of an accountant should be obtained to ensure that persons involved with the FLLC are retaining and treating information in an appropriate manner for federal and state tax purposes. The accountant will provide ongoing tax return preparation and accounting services to the FLLC. If the FLLC owns assets other than marketable securities, retaining a bookkeeper in addition to an accountant should be considered. A bookkeeper can help ensure that the FLLC Operating Agreement is followed with regard to the members' capital accounts and income and loss allocations.

B. Each year the FLLC must file Federal Form 1065 and Kansas Form K-65. Moreover, if the FLLC provides a salary to an employee, the FLLC must withhold and report the employment taxes on this salary. Because the FLLC is a "pass-through" tax entity, it must provide the members with information regarding their distributive share of income, deductions, and credits in a timely manner. If the FLLC is engaged in an active trade or business, the members may need to pay self-employment tax on their distributive share of the company's earnings.

The company's accountant should be consulted regarding the need to pay such self-employment tax.

C. Subject to the provisions of the FLLC's Operating Agreement, all distributions should be made to the members in proportion to their percentage in the FLLC. No disproportionate distributions should be made without first consulting with us or with the company's accountant, and then only after careful documentation of the effect of the disproportionate distribution (e.g. treated as a loan, reduction of a capital account, etc.). Recent judicial decisions have emphasized that a senior family member's ability to control the flow of income from a FLLC may jeopardize some of the tax benefits of creating the FLLC. Consequently, decisions pertaining to distributions of the Company's income should be made by all members in a meaningful way and not be controlled solely by the senior generation members.

D. Management of the day-to-day affairs of the FLLC business should be accomplished in the name of the entity and not in a personal capacity. The complete FLLC name should be used on all letterhead, bank accounts, etc. When signing documents on behalf of the FLLC, the person signing the documents should always make clear that he or she is acting as either the company's manager or as a member. Some companies are member managed and do not have separate managers. In a member-managed company, certain members may be designated to sign documents on behalf of the company. If the

company is managed by a manager, who will probably also be a member, the manager should sign such documents. Regardless of whether one signs as a manager or member, the capacity in which that person signs should be noted with the signature. If the capacity of the person signing is not properly noted, the person may be considered to be acting in a personal capacity and thus be personally liable for the company's obligations. An example of an acceptable signature would be as follows:

John Q. Public, Member, Public Family, L.C.

E. The FLLC's income should be segregated from personal income and assets. For example, FLLC income must be deposited into an FLLC bank account, not a personal bank account. Moreover, any personal use of FLLC assets should be clearly documented and accompanied by a written lease and fair market rental payments. For example, if a member uses FLLC real property for vacation purposes, that member should pay the FLLC a fair rental value for such use.

F. All nontax purposes for the creation of the FLLC should be clearly and regularly documented. For example, if a child has a creditor problem or an asset has high liability risks, the use of an FLLC is prudent business practice. Noting in minutes such reasons for establishing and operating the FLLC can be helpful to support the FLLC's valid business purpose.

G. The members of the FLLC should adhere to the Operating Agreement regarding FLLC operational procedures, including holding scheduled meetings and disseminating regular financial reports to members. Each member should make capital contributions and the FLLC should maintain a schedule showing the capital contributions of each member. The capital account schedule should be regularly updated and circulated among the members. Whenever real property or other assets which are not readily marketable or cash are transferred to the FLLC, a contemporaneous, written appraisal should be obtained. In addition, a written appraisal should be obtained whenever there is a transfer of a membership interest

H. Whenever the FLLC convenes a meeting of the members, minutes should be recorded and maintained.

I. Appropriate insurance coverage (property, liability, etc.) should be obtained in the FLLC's name in situations where the FLLC is intended to do more than hold and manage securities.

J. The FLLC should strive to conduct business or investment activity. This may be as simple as looking for investment opportunities, reshaping original holdings, or seeking advice from brokers and investment advisors regarding particular purchases.

K. The separate entity status of the company, as distinct from the individual members, must be emphasized. For example, if a member is not

comfortable with a particular investment or wants funds for personal use, that member should request the liquidation of his or her membership interest. The manager or other members can then consider the request at length and document his, her, or their conclusions. If the request is denied, the member should be so advised, citing the business need to keep the interests aggregated.

L. If additional or new contributions of capital are made to the FLLC, those infusions of capital must be properly reflected and the donor's capital account increased. If this is not done, there may be a deemed gift to the other members to the extent that capital accounts were increased by reason of the contribution by one of the members.

M. If gifts of FLLC interests are made, we urge the Member who makes the gift to contact us to determine whether a gift tax return must be filed, and, if so, whether a formal appraisal is necessary.

N. We recommend that a "reasonable period of time" pass between formation of the FLLC and the date of a subsequent gift of an FLLC membership interest. There is no safe harbor as to what constitutes a "reasonable period of time." Therefore, we advise waiting, at a minimum, twelve months from the date of formation to the date of subsequent gift. Although this guideline has no express statutory, regulatory, or judicial support, we believe twelve months should be a sufficient period of time to meet the "reasonable period of time" standard.

CONCLUSION

Families who establish FLLC's must strive to preserve the separate, distinct legal status of the FLLC to realize gift and estate tax opportunities, and to preserve the limited liability of the FLLC's members. Therefore, we strongly urge adherence to the guidelines outlined in this memorandum. Even then, in many circumstances the tax and legal aspects of proposed conduct may be unclear. Therefore, we encourage FLLC members to contact us if they should have concerns or questions regarding how a proposed action will affect the FLLC.