The New Nevada Restricted LLC and LP Legislation: A "Why?" and "How to?" Guide

By Steven J. Oshins

Nevada Senate Bill 350 was signed into law by the Governor of Nevada on May 29, 2009 and is effective October 1, 2009. This Bill was sponsored by the Business Law Section of the State Bar of Nevada. A portion of this Bill creating a new form of business entity called a Restricted LLC and Restricted LP (jointly referred to herein as "Restricted Entity" or "Restricted Entities") was drafted by the author of this article with the review and approval of the Business Law Section. *The author of this article wishes to thank the members of the Business Law Section for their hard work and guidance and for allowing the Restricted Entity language to be a part of their Bill.*

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Valuation discounts

Many advanced gift and generation-skipping transfer tax leveraging techniques rely on valuation discounts to reduce the fair market value of assets in order to transfer those assets out of a wealthy person's estate with little or no tax. Transfer tax strategies utilizing family limited liability companies and family limited partnerships work well in large part because of the ability to discount the transferred interests to reflect the fact that the interests are less valuable than pro rata value because of the willing buyer/willing seller test promulgated by the Internal Revenue Code.

Under Internal Revenue Code §2704(b), and Treasury Regulations §25.2704-2(a), if an interest in an entity is transferred to or for the benefit of a member of the transferor's family, any applicable restriction is disregarded in valuing the transferred interest. Treasury Regulations §25.2704-2(b) defines an applicable restriction as a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction.

Until now, all states have been limited to some form of the Uniform Laws. A number of states, including Nevada, have had favorable default restrictions that allow for slightly higher valuation discounts than the discounts that can be obtained using other states' laws. With the passage of SB 350, Nevada has now separated its valuation discount opportunities significantly in comparison to all other states.

New ceiling under IRC §2704(b)

The difference between the Restricted Entities and regular LLCs and LPs is that the Restricted Entities have a default statute locking in the entity's underlying assets for a ten-year period. This creates a new significantly higher ceiling on valuation discounts that is not available in any other state.

This does not mean that the drafting attorney must lock the underlying assets in for the entire ten years. Rather, the Restricted Entity might be drafted to lock the underlying assets in for a lesser number of years. Alternatively, the

Restricted Entity might be drafted to lock the underlying assets in for ten years but with the discretionary right to distribute up to a small percent or dollar amount of the assets per year or to distribute an amount not exceeding the underlying income. In other words, the possibilities are endless. The creative estate planner will design the Restricted Entity around the contemplated transaction.

What the appraisers say

The author of this article asked appraisers at two different business valuation appraisal firms ("Appraiser #1" and "Appraiser #2", respectively) to each independently prepare a memorandum responding to certain hypothetical questions posed by the author of this article. Appraiser #1 is Steve Nicolatus (wevc@qwest.net) and Peter Agrapides (panayotiagra@yahoo.com), both of Houlihan Valuation Advisors, in Las Vegas, Nevada and Salt Lake City, Utah. Appraiser #2 is Don Parker (dparker@bizvals.com) of Gryphon Valuation Consultants of Las Vegas, Nevada. These hypotheticals have been previously published in Steve Oshins, "FLASH – Nevada Restricted LLC and LP Laws Enacted," LISI Estate Planning Newsletter #1471, dated May 30, 2009.

The questions were asked for the specific purpose of obtaining an estimate of the additional valuation discounts that should be available using the Restricted Entities. The appraisers were specifically told that the author may cite portions of the responses in articles but with the limitation that these are only estimates and that they may not necessarily be followed in an actual appraisal requiring more extensive research and an application to actual facts.

Hypothical #1: The Restricted Entity disallows any Member/Partner distributions for 10 years. Appraiser #1 estimated an additional 10% to 30%+ discount on top of the discount that would be obtained without this additional provision. Appraiser #2 estimated an additional 15% to 35% discount on top of the discount that would be obtained without this additional provision.

Hypothical #2: The Restricted Entity disallows any Member/Partner distributions for 5 years. Appraiser #1 estimated an additional 5% to 20%+ discount on top of the discount that would be obtained without this additional provision. Appraiser #2 estimated an additional 10% to 25% discount on top of the discount that would be obtained without this additional provision.

Hypothical #3: The Restricted Entity disallows any Member/Partner distributions for one year. Appraiser #1 estimated an additional 3% to 10% discount on top of the discount that would be obtained without this additional

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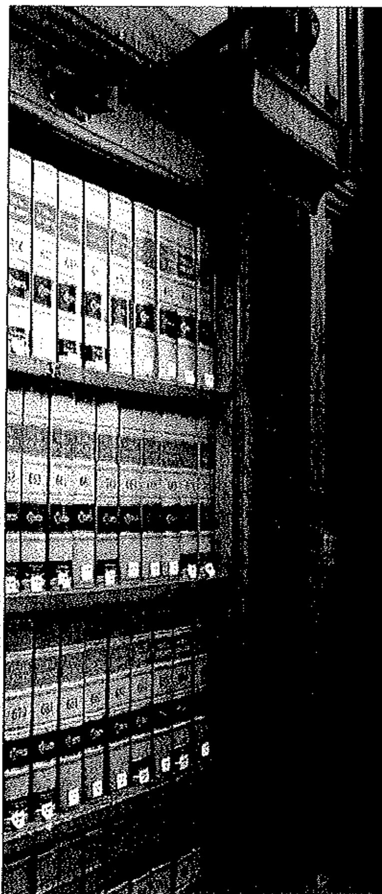

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provision. Appraiser #2 estimated an additional 3% to 10% discount on top of the discount that would be obtained without this additional provision.

Hypothical #4: The Restricted Entity disallows any Member/Partner distributions ranging from 1 to 10 years, except to allow all income/growth beyond the capital contributions to be distributed. Appraiser #1 estimated an additional 3% discount for a 1-year restriction to 10% for a 10-year restriction on top of the discount that would be obtained without this additional provision. Appraiser #2 estimated an additional 2% discount for a 1-year restriction to 15% for a 10-year restriction on top of the discount that would be obtained without this additional provision.

Hypothical #5: The Restricted Entity disallows any Member/Partner distributions ranging from 1 to 10 years, except to allow an amount equal to the highest federal/state income tax to be distributed to eliminate the taxation on phantom income. Appraiser #1 estimated an additional 2% discount for a 1-year restriction to 10% for a 10-year restriction on top of the discount that would be obtained without this additional provision. Appraiser #2 estimated an additional 3% discount for a 1-year restriction to 15% for a 10-year restriction on top of the discount that would be obtained without this additional provision.

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How to opt into the restricted entity

Creating a Restricted Entity is simple. The statute was written with the goal of making it as easy as possible on the draftsman to elect into the Restricted Entity rules. The statute simply requires the draftsman to elect in the Articles of Organization or the Certificate of Limited Partnership to have the entity treated as a Restricted Entity.

If the Articles of Organization or Certificate of Limited Partnership states nothing more than that the Restricted Entity election is being made then the ten-year lock-in period will apply. Therefore, the draftsman should add additional language to the Articles of Organization or Certificate of Limited Partnership stating exactly to what extent the draftsman intends to add an additional restriction within the ten-year ceiling. An additional sheet of paper should be submitted along with the Articles of Organization or Certificate of Limited Partnership. Therefore, there is plenty of room to provide the specific restrictions.

In order to maintain consistency, the draftsman should draft identical additional restrictions into the operating agreement or limited partnership agreement. This will avoid a situation where the operating agreement or limited partnership agreement is inconsistent with the Articles of Organization or Certificate of Limited Partnership.

The Green Book

The Treasury Department's "Green Book" was released on May 11, 2009. One of the proposals in the Green Book seeks to modify the application of IRC §2704(b) such that disregarded restrictions would include restrictions on liquidation of an interest that are measured against standards prescribed in the Treasury Regulations rather than against default state law.

There have been a number of other recent proposals that attempt to curb valuation discounts. It is likely that at some point there will be some changes to our valuation system.

However, the willing buyer/willing seller definition found in the estate and gift tax Treasury Regulations would be disrupted significantly with any modifications that do not reflect real restrictions on business interests. Because of this, there are a number of large groups lobbying against any significant modifications to these laws. C

Steven J. Oshins is an estate planning and asset protection attorney at the Law Offices of Oshins & Associates, LLC in Las Vegas, Nevada. He authored the Nevada Restricted LLC and LP laws in the 2009 legislative session. Steve can be reached at 702-341-6000, ext. 2 or at soshins@oshins.com. His Web site is www.oshins.com.