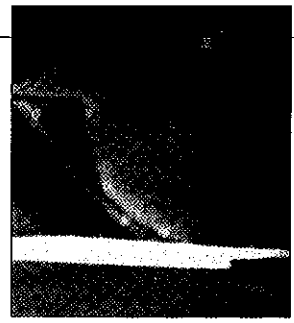

New Nevada Restricted LLC and LP Law: An Ideal Combination With a Graduated GRAT

New Nevada legislation permits the creation of restricted entities that provide enhanced valuation discount opportunities that are not available in any other state. A good strategy is to use the new law with a graduated GRAT.

STEVEN J. OSHINS, ATTORNEY AND ROBERT S. KEEBLER, CPA

Many advanced transfer tax leveraging techniques rely on valuation discounts to increase the assets removed from the taxable estate. Transfer tax strategies using family limited liability companies ("LLCs") and family limited partnerships ("FLPs") work well in large part because of the ability to discount the transferred interest to reflect the fact that the interests in such an entity are worth less than pro rata value accorded by the willing buyer/willing seller test in the Regulations.[1]

Under IRC Section 2704(b) and Reg. 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. Reg. 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 slightly higher valuation discounts than the discounts that can be obtained using other states' laws. Nevada has now increased its valuation discount opportunities significantly in comparison to all other states.

Nevada Senate Bill 350

Nevada Senate Bill 350 was signed into law by the Governor of Nevada on 5/29/2009. One of the provisions of the new law allows the creation of a restricted LLC and a restricted LP[2] (jointly referred to herein as "Restricted Entity" or "Restricted Entities"). Both types of Restricted Entities create enhanced valuation discount opportunities that are not available in any other state. The new law allows Restricted Entities to be created beginning 10/1/2009. The primary provisions of the new law can be read in Exhibits 1 and 2.

The difference between the Restricted Entities and regular LLCs and LPs is that the Restricted Entities have a default statute restricting member or partner distributions for a ten-year period. This creates a new, significantly higher ceiling on valuation discounts that is not available in any other state.

New ceiling under Section 2704(b)

The Nevada Restricted Entity statutes create a new ceiling on val-

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EXHIBIT 1
New Statutes—Restricted LLC

The primary statutory provisions creating the restricted LLC laws read as follows:

1. "Restricted limited-liability company" means a limited-liability company organized and existing under this chapter that elects to include the optional provisions permitted by NRS 86.161.
2. If a limited-liability company has elected in its articles of organization to be a restricted limited-liability company pursuant to NRS 86.161, subject to the provisions of NRS 86.343, and unless otherwise provided in the articles of organization, the company shall not make any distributions to its members with respect to their member's interests until 10 years after:
   (a) The date of formation of the restricted limited-liability company as long as the original articles of organization elected to be treated as a restricted limited-liability company and as long as the company has remained a restricted limited-liability company since the date of formation; or
   (b) The effective date of the amendment to the articles of organization in which the company elected to be treated as a restricted limited-liability company and as long as the company has remained a restricted limited-liability company since the effective date of the amendment.
3. The provisions of this section apply as the default provisions of a restricted limited-liability company to the extent the provisions of this section are inconsistent with or add to the other provisions of this chapter and to the extent not otherwise modified in the articles of organization of the restricted limited-liability company.

uation discounts that no other state allows. This does not mean that the drafting attorney must lock the underlying assets in for the entire ten years. Rather, the articles of organization or certificate of limited partnership might be drafted to lock the underlying assets in for a lesser number of years.

Alternatively, the articles of organization or certificate of limited partnership 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 income earned from the underlying assets. Yet another option is to allow the entity to distribute an amount not to exceed the income tax liability caused by 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

One of the authors of this article asked appraisers at two different business valuation appraisal firms ("Appraiser #1" and "Appraiser #2," respectively)[3] to each independently prepare a memorandum responding to certain hypothetical questions posed by the author of this article.[4] 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 might 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 requir-

[1] Regs. 20.2031-1(b) and 25.2512-1.

[2] The Restricted LLC and Restricted LP statutes were drafted by Steven J. Oshins and were given these names by Mr. Oshins to reflect the additional restrictions built into the statutes. Mr. Oshins would like to acknowledge the work of the Business Law Section of the State Bar of Nevada for adding the Restricted LLC and Restricted LP language to its legislative bill and Attorney Rob Kim, Chairperson of the Business Law Section, for integrating Mr. Oshins' language into the legislative bill.

[3] Appraiser #1 is Steve Nicolatus (wevc@qwest.net) and Peter Agrapides (panayotiagra@yahoo.com), both of Houlihan Valuation Advisors, in Las Vegas and Salt Lake City. Appraiser #2 is Don Parker (dparker@bizvals.com) of Gryphon Valuation Consultants in Las Vegas.

[4] These hypotheticals were previously published in Oshins, "FLASH—Nevada Restricted LLC and LP Laws Enacted," Steve Leimberg's Estate Planning Newsletter #1471 (5/30/2009) (www.leimbergservices.com; LISI).

EXHIBIT 2
New Statutes—Restricted LP

The primary statutory provisions creating the restricted LP laws read as follows:

1. "Restricted limited partnership" means a limited partnership organized and existing under this chapter that elects to include the optional provisions permitted by NRS 87A.235.
2. If the limited partnership has elected in its certificate of limited partnership to be a restricted limited partnership pursuant to NRS 87A.235, subject to the provisions of NRS 87A.425, and unless otherwise provided in the certificate of limited partnership, the limited partnership shall not make any distributions to its partners until 10 years after:
   (a) The date of formation of the restricted limited partnership as long as the original certificate of limited partnership elected to be treated as a restricted limited partnership and as long as the limited partnership has remained a restricted limited partnership since the date of formation; or
   (b) The effective date of the amendment to the certificate of limited partnership in which the limited partnership elected to be treated as a restricted limited partnership and as long as the limited partnership has remained a restricted limited partnership since the effective date of the amendment.
3. The provisions of this section apply as the default provisions of a restricted limited partnership to the extent the provisions of this section are inconsistent with or add to the other provisions of this chapter and to the extent not otherwise modified in the certificate of limited partnership of the restricted limited partnership.
4. If the limited partnership has elected in its certificate of limited partnership to be a restricted limited partnership pursuant to NRS 88.350, subject to the provisions of NRS 88.520, and unless otherwise provided in the certificate of limited partnership, the limited partnership shall not make any distributions to its partners with respect to their partnership interests until 10 years after:
   (a) The date of formation of the restricted limited partnership as long as the original certificate of limited partnership elected to be treated as a restricted limited partnership and as long as the limited partnership has remained a restricted limited partnership since the date of formation; or
   (b) The effective date of the amendment to the certificate of limited partnership in which the limited partnership elected to be treated as a restricted limited partnership and as long as the limited partnership has remained a restricted limited partnership since the effective date of the amendment.
5. The provisions of this section apply as the default provisions of a restricted limited partnership to the extent the provisions of this section are inconsistent with or add to the other provisions of this chapter and to the extent not otherwise modified in the certificate of limited partnership of the restricted limited partnership.

ing more extensive research and an application to actual facts.[5]

Hypothetical #1. In this hypothetical, the Restricted Entity disallows any member/partner distributions for ten 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.

Hypothetical #2. Here, the Restricted Entity disallows any member/partner distributions for five 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.

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

Hypothetical #4. The Restricted Entity in this case disallows any member/partner distributions ranging from one to ten years, except to allow all income/growth beyond the capital contributions to be distributed. Appraiser #1 estimated

[5] Both appraisers specifically noted certain attributes of the underlying assets of the Restricted Entities that would help determine whether the restriction would cause higher or lower discounts. For purposes of simplicity, those factors have not been specified herein.

an additional 3% discount for a one-year restriction to 10% for a ten-year restriction on top of the discount that would be obtained without this additional provision. Appraiser #2 estimated an additional 2% discount for a one-year restriction to 15% for a ten-year restriction on top of the discount that would be obtained without this additional provision.

Hypothetical #5. Here, the Restricted Entity disallows any member/partner distributions ranging from one to ten 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 one-year restriction to 10% for a ten-year restriction on top of the discount that would be obtained without this additional provision. Appraiser #2 estimated an additional 3% discount for a one-year restriction to 15% for a ten-year restriction on top of the discount that would be obtained without this additional provision.

The graduated GRAT

One leveraging technique that is often combined with valuation discount planning is the grantor retained annuity trust ("GRAT"). A GRAT is an irrevocable trust to which the settlor gives an asset in exchange for an annuity generally payable for a term of years. If the annuity is structured as a qualified annuity, the value of the annuity may be subtracted from the value of the asset transferred to the GRAT to determine the value of the gift.[6] Because of this subtraction method of calculating the taxable gift, it is possible to structure the annuity so that the total taxable gift by the settlor is zero or close to zero.

A GRAT has several benefits. First, it is a strategy specifically sanctioned by the Internal Revenue Code, and therefore it is acceptable to the IRS if structured properly. Additionally, the annuity amount paid can be structured as a percentage of the initial fair market value ("FMV") of the trust rather than as a dollar figure. Therefore, if the IRS challenges the FMV of the asset transferred to the GRAT, the annuity will automatically adjust itself and should not cause significant gift tax exposure to the settlor.

Nevada has now increased its valuation discount opportunities significantly in comparison to all other states.

In order for a GRAT to be successful in transferring assets outside the settlor's taxable estate, the settlor needs to survive the term of years selected. If the settlor dies during the term of the GRAT, some or all of the GRAT assets will be included in the settlor's estate under Section 2036(a).[7]

To obtain greater transfer tax leverage, the GRAT can be designed so that annuity payments are backloaded (a "graduated GRAT"). However, the IRS does not allow the annuity payment to increase from one year to the next by more than 20% of the previous year's payment.[8]

A wealthy estate owner will often transfer discountable income-producing assets into the GRAT. Because of the valuation discount, the required annuity payments will be lower than they would be if no discount applied. The larger valuation discount enables the planner to shorten the term of the GRAT and, thus, lower the mortality risk.

Design options

There are two main structural options that should be considered in planning and drafting a Restricted Entity in contemplation of a gift to a graduated GRAT.

One option is to design the Restricted Entity to allow a distribution, in the first fiscal year, of a relatively small percentage of the FMV of the assets initially contributed to the Restricted Entity, followed each successive year by a slightly larger allowable amount that can be distributed. All other assets contributed to the Restricted Entity would be restricted from being distributed to the owners, thereby allowing for a greater valuation discount than would occur with a traditional business entity.

For example, the articles of organization or certificate of limited partnership might contain the following statement:

> The allowable member/partner distributions that can be made during the first fiscal year of the LLC/LP shall be limited to 5.0% of the fair market value of the underlying assets owned by the LLC/LP as of [date]. Each fiscal year thereafter until ten years after the date the Articles of Organization/Certificate of Limited Partnership was originally filed with the Nevada Secretary Of State, said allowable member/partner distributions shall be increased by 20.0% over the prior fiscal year's allowable member/partner distributions so that each subsequent fiscal year's allowable member/partner distributions shall equal 120.0% of the prior fiscal year's allowable member/partner distributions. Any prior fiscal year allowable distributions, to the extent not made in said prior fiscal year, shall not be cumulative and thus

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[6] See Section 2702.

[7] TD 9414 (7/14/2008). See also REG-119532-08 (4/30/2009).

[8] Reg. 25.2702-3(b)(1)(ii).

the Section 7520 rate, the lower the value of the retained interest and the higher the taxable gift.

A nervous client, however, should like a QPRT because he or she can live in his or her house for the term of the QPRT on a rent-free basis. In other words, nothing will change for the client during the term of the QPRT: the client continues to live in the residence rent-free. If the house grows in value during the trust term at a rate that exceeds the Section 7520 rate, the client will have made an efficient gift. The client, of course, will have to rent back the house if he or she wants to live in the house when the term expires, but that could be an effective wealth transfer, particularly if the house is held in a grantor trust after the expiration of the QPRT term.

A client may object to the use of a QPRT because of the rent-back rules at the end of term. That client, however, could always purchase the house from the remainder beneficiaries of the QPRT. The QPRT Regulations allow such a sale as long as the seller is not a grantor trust. Thus, if the remainder beneficiaries are individuals or the follow-on trust is a nongrantor trust, the donor can buy back the house. If the house has not increased in value beyond the client's basis, the sellers—the remainder beneficiary or beneficiaries—will not recognize any gain on the sale. If the house has increased in value beyond the client's basis, the remainder beneficiaries could report the gain on the installment method, thereby allowing them to spread out the capital gains tax over the life of the promissory note.

Part 2 of this article will appear in the next issue of ESTATE PLANNING. It will analyze getting a "do-over" on gifts and stopping the bleeding when transferred assets decline in value. ■

NEVADA LLCs AND LPs

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may not be made in a subsequent fiscal year. Notwithstanding the foregoing, since the tenth fiscal year of said limitations on member/partner distributions will not be a full year, the allowable distributions for said tenth fiscal year shall be limited as provided herein for said partial fiscal year but not thereafter.

The second option is to draft the Restricted Entity to take full advantage of the ten-year restriction that the new Nevada law allows and to supplement the gift of the Restricted Entity interest with cash or cash-like assets in an amount equal to the anticipated annuity payments. Whether this approach will be better or worse than the first option will depend on various factors, including the appropriate valuation discount determination of the business valuation appraiser.

The Green Book

The Treasury Department's "Green Book" was released on 5/11/2009. One of the proposals in the Green Book seeks to modify the application of Section 2704(b) so that disregarded restrictions would include restrictions on liquidation of an interest that are measured against standards prescribed in the 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 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. ■

NEW FIDUCIARY DECISIONS

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In examining the record, the appellate court stated that the personal representative offered evidence that a private sale of the realty would result in a greater return to the estate whereas the heirs (the children) presented no evidence on the issue. Presumably, the heirs felt that they had a right to partition by sale and that the statute granted them that right. The Nebraska court, however, emphasized the statutory right of the personal representative to dispose of an asset at a private sale and sell real property unless restricted by order of the court.

In the instant case, the supreme court concluded that the probate court restricted the personal representative from selling the property by private sale when it ruled against her. The lower court order implied that the personal representative must sell the property at a public sale. The appellate court determined that the record did not support a finding that such a sale would be the most economically efficient method. It is counterintuitive that the heirs would argue for a result that was not in their best economic interest. Be that as it may, the *Failla* result might be best explained by the old adage that at death, property passes "*subject to administration.*" ■