The Use of Limited Liability Companies in Estate Planning

There are certain advantages to placing your investment property or business interests in a limited liability company ("LLC"). An LLC is a form of business organization that combines the corporate benefit of limited liability with the partnership benefit of pass-through tax treatment. An LLC is sometimes referred to as a hybrid between a partnership and a corporation but structurally is more like a partnership than a corporation. An LLC is similar to a partnership and may be treated as a partnership for tax purposes; however, an LLC has some advantages over either a general or limited partnership.

An LLC is formed by contributing your investment property to the LLC in exchange for LLC units. Two separate legal documents are required to create the LLC. The first is a short document called "Articles of Organization." Articles of Organization must be filed with the state to create the LLC. The second document is a longer, more detailed operating agreement governing the LLC's operations.

Persons who own LLC units are "members." Members have both economic and management rights and will have limited liability for the LLC debts or claims. You can create a "member-managed" LLC where all of the members have a say in the operation of the LLC, or a "manager-managed" LLC where you would retain control of the LLC as the managing member. You may, if you wish, subsequently make gifts of LLC units to your children or others.

Gifting

Gifts of units in an LLC to family members or others may be made for estate planning purposes in amounts approximating the annual exclusion from gift taxes (currently $13,000). Gifts of LLC units are much easier to make than gifts of undivided interests in real property or other hard-to-divide personal assets. Gifts of undivided interests in real property require deeds conveying the interests in the property, and if the value of the property transferred is small in relation to the entire property, the resulting fractional interests can be inconveniently small. Gifts of individual assets involve a consideration of differing tax basis as well as other factors such as individual prospects for appreciation and suitability to the recipient. In contrast, a gift of an LLC unit is accomplished by a simple assignment and no deeds conveying property or allocations based on individual factors are required.

Creditor Protection

Creditors of an LLC member will have significantly more difficulty reaching the assets of the LLC than they would if the assets were owned by the member outright.

Probate Avoidance

If you form an LLC and fund it with all of your interest in any out-of-state property, your personal representative will not need to open a probate in that state in order to distribute the property to your descendants after your death. If you have out-of-state real property, this can be a significant benefit. However, LLC units may be subject to probate unless held in a revocable trust.

Management

An LLC provides a management vehicle for you to manage any property that you may choose to contribute to the LLC. In addition to providing a structure for making managerial decisions about the property, the LLC agreement provides a means for you to transfer interests in the property down to others in the next generation. An LLC agreement also typically contains transfer restrictions that prevent nonmembers (such as spouses or other family members) from having an interest in the LLC upon the death, incapacity or divorce of a member. Finally, an LLC allows you to transfer a large portion of your investment property to your children or others for estate planning purposes, while retaining your right as a managing member of an LLC to control the property.

Estate Tax Consequences

An LLC may reduce your estate tax liability, depending on the amount and type of LLC units that you hold at your death. In valuing your interest in the LLC for estate tax purposes, an appraiser generally will consider the relative marketability and control represented by the interests that you held at the time of your death. The value of your interests may be "discounted" for lack of marketability. If you owned less than a controlling interest in the LLC, your interest may also be entitled to a minority interest discount. However, you should note that the Internal Revenue Service has been challenging the use of discounts. Any discount taken should be documented with a qualified appraisal. Because of the uncertainty regarding the availability of discounts, you should not create an LLC for the sole purpose of obtaining discounts.

To illustrate the potential savings of discounts, assume an individual dies while he or she is the sole owner of property with a fair market value of $10,000,000. Because the property was owned outright by the individual, the value of the property for estate tax purposes would be the full $10,000,000. If instead the individual held the property with family members in an LLC that was properly structured, the value of the interest for estate tax purposes could be 20 percent to 40 percent less, or somewhere in the range of $6,000,000 to $8,000,000 instead of the full $10,000,000. With federal estate tax rates approaching 50 percent in 2011, approximately $2,000,000 in estate tax could be saved. These savings reflects the economic reality that sole ownership is more valuable to a purchaser than ownership entangled with the rights of others, both in regard to marketability and the control of the underlying assets.

Gift Tax Consequences

Similar discounts are available when making gifts of the LLC units. The effect of making annual exclusion gifts can therefore be increased. For example, a gift of an LLC interest worth $13,000 may pass $15,000 to $20,000 worth of underlying LLC assets to your children or grandchildren, depending on the discounts used. An appraisal of the fair market value of the LLC is generally needed when a significant gift is made so that your records will document the fact that the value of the gift was $13,000 or less. You should note that the Internal Revenue Service may challenge significant discounts taken on the value of these gifts.

Disadvantages

The major disadvantages associated with creating an LLC for your investment property are the legal and accounting costs associated with setting up the LLC, appraising the value of any gifts, and preparing gift, partnership and other tax returns. In addition, structuring an LLC and gifting LLC units are often irrevocable transactions and cannot be undone without considerable effort, if at all. Depending upon the type of property transferred to the LLC, there may be transfer taxes or other costs imposed by local law. While the LLC manager retains management control and may draw compensation for this management, any distributions in excess of reasonable compensation should be made proportionately to all members. Similarly, while the compensation for the manager is income to him or her and deductible on the LLC tax return, all taxable income, deductions and credits of the LLC generally pass out to the members proportionately. If property contributed to or owned by an LLC is subject to a mortgage, taxable gain may be recognized in certain circumstances if the basis in the property is less than the outstanding debt at the time of the transfer of the property interest.

Conclusion

An LLC offers a number of non-tax benefits, including the ability to conveniently manage your investment property during your life. An LLC also offers significant estate tax advantages and may facilitate the transfer of your interest in the property through lifetime gifts or following your death. Both are especially well suited for owners of real estate and commercial assets, but they can also offer advantages where an owner wishes to consolidate financial holdings in order to centralize management, obtain administrative savings and economies of scale, maintain diversification, facilitate gifting objectives, and anticipate diffusion of ownership.

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