# Estate Planning Strategies Using LLC's, Part One

By Jim Gulseth

**Why and how do we use LP’s (limited partnerships) and LLC-P’s (limited liability companies taxed as a partnership) for estate planning?**

(a) Why is entity ownership of assets better than individual/fractional ownership?

- California Transfer Tax Reasons: Real estate tax and transfer tax freezes, IRS Chapter 14 Rules anti-abuse regulations, valuation discounts.
- Non-Property/Transfer Tax Reasons: Asset protection, facilitates interest transfers, exempt annual gifts $13,000, centralized management, private resolution of disputes, allows retaining control, continuity of entity because the entity survives the death of a member, ease of probate, preserve step-up in basis, self-employment tax issues.

(b) Why is individual/fractional ownership better than entity ownership?

- Avoid formation and maintenance costs, franchise/gross receipt taxes, flexibility in structuring.

(c) Why do we prefer entities taxed as a partnership, such as a limited partnership (“LP”), a limited liability company taxed as a partnership (“LLC-P”) or a limited liability company taxed as a disregarded entity (“LLC-D”) for estate planning purposes over corporate entities and other entities taxed as a corporation, including limited liability companies taxed as an “S” corporation (“LLC-S’s”) and limited liability companies taxed as a “C” corporation (“LLC-C’s”)?

- Taxation: One level of taxation - no double taxation, special allocations of profits and losses for partnership entities for inside and outside step-up in basis (704), tax-free transfer of property to and from the entity. Transfers to an entity taxed as a corporation may be taxable unless §351 applies. Losses deductible by members up to their basis in membership interest (basis includes LLC debt) ownership. No limit on the type of members who can hold ownership interests such as apply to 'S' corporations. No

restrictions on the types (classes) of membership interests that may be issued. 'S' corporations can only issue one class of stock.

- Asset protection: Reverse alter ego (outside liability) protection better for an LLC.

(d) Why would we prefer to use partnership entities such as LP's and LLC-P's over trusts?

- To avoid compressed income tax rates on trusts. An irrevocable accumulation trust will be taxed at the highest marginal rate on income in excess of $9800. The pass-through partnership entities such as LP's and LLC-P's allow income to pass through to its members whether or not the income is distributed. Some of these members will likely be in lower tax brackets than the granting, donor or senior generation.
- To provide for private resolution of disputes, state law limits a grantor's right to restrict the remedies of beneficiaries (see Probate Code Section 21300 et seq.). LP's and LLC-P's may use arbitration clauses to force members and the entity to resolve disputes in less expensive and time consuming manners.
- To reduce the rights of non-members and non-family members to acquire interests. Divorces and creditors can lead to problems with outright ownership of trust interests by outside parties. LP's, LLC-P's and LLC-D's can limit the rights of in-laws or creditors to interfere with family assets.
- Use of a LP or LLC-P may help reduce the impact of income in respect of a decedent (IRD) upon the death of a member by requiring the entity to close on the death of a member.
- Use of an LP, LLC-P or LLC-D allows for reduction of estate and gift taxes because of the application of asset freeze and transfer discount strategies.
- If there are substantial assets outside of California, a non-California LP, LLC-P or LLC-D may be used in some circumstances to reduce California's ability to tax out-of-state activities.

(e) Why would an LLC-P be better than an LP?

- Flexibility in organization and capital structure.
- Simplicity of structure, one entity to obtain limited liability for all.
- Limited liability for all - Passive members do not risk exposure by taking part in the control of the business, which would potentially expose limited partners to both inside-out liabilities (alter ego) and outside-in liabilities (reverse alter ego).
- LLC-P allows participation in management by all members without risk of liability.
- All debt of the LLC-P is non-recourse, creditor remedy against a member is limited to a charging order.
- LLC Act provides answers to many issues and clear default rules Corporation Code §17000 et seq.
- No limitation on step-up in basis for assets of LLC when management dies such as for a limited partnership with an individual general partner (GP).

(f) Why would a California limited partnership ("LP") be better than a California limited liability company taxed as a partnership ("LLC-P")?

- No California gross receipts taxes.
- Reduced self-employment tax confusion, distributions to limited partners clearly not subject to self-employment tax.
- Long history of limited partnership statutory law and cases; the Uniform Limited Partnership Act tends to promote unity of limited partnership laws among the states. California Corporations Code §15001 et seq. California Revised Limited Liability Act effective January 1, 2008 (California Corporations Code Sections 15611 et seq.
- Inconsistency of LLC laws from state-to-state.
- Chapter 14 issue (IRC §2704(b) - LLC restrictions beyond LLC statute default provisions not enforceable for purposes of valuation. For purposes of valuing the lack of liquidity (the right to liquidate) an appraiser must disregard any restriction on liquidation that is beyond that required by state law. California default provisions for an LLC provide that a

California LLC shall be dissolved and its affairs wound up upon the "vote of a majority in interest of the members, or a greater percentage of the voting interests of members as may be specified in the articles of organization or a written operating agreement." Corporations Code §17350(b). Under California law, unless otherwise set forth in the limited partnership agreement, a California LP may be dissolved only upon vote of a majority of the limited partners and all of the general partners.

(g) Solutions to the Chapter 14 issue for a California LLC include:

- Use an LLC from a jurisdiction that requires, as a default, the unanimous vote of all members to liquidate the LLC and register it in California. Jurisdictions such as Nevada and Wyoming, require as a default unanimous vote of all members to liquidate.
- Make sure the donor does not own a majority of interests in the California LLC at the date of the bequest (death) or that (s)he does not gift 51% of the membership interests at one time (within the same taxable year).
- Argue the California statute default also includes "a greater percentage of the voting interests of members as may be specified in the articles of organization or a written operating agreement." Corporations Code §17350(b).

**Using LLC-P's as an Alternative to LP’s for Estate Planning Purposes**

Historically, most estate planning strategies were carried out through limited partnerships (sometimes called “Family Limited Partnerships” or “FLPs”). First of all, limited partnerships have been available for use for this purpose for many years, whereas limited liability companies have only been available since the 1990’s. Evan after limited liability companies became available as an alternative to limited partnerships, there were many reasons why California advisors had a preference for limited partnerships over LLC-P’s. Such reasons included the advisors’ failure to understand LLC-P’s and how to structure LLC-P’s to function as a substitute for LP’s, the longer history of case law in handling limited partnerships, the frequent use of LP’s in the mid-1980's for syndicated tax shelters and their immediate familiarity to practitioners and

clients alike; the relative newness of the LLC structure in the law, and inconsistency from state to state in the laws governing LLC operation. Over time, as the laws became more or less understood and/or uniform in certain respects, and as cases began appearing interpreting LLC laws, LLC-P's have become increasingly popular as a substitute (or supplement, in some cases) to family limited partnerships.

The main feature of a limited partnership that distinguishes it from a LLC-P is that the general partner(s) of a limited partnership are subject to unlimited liability for the acts of the entity, while no member (managing member, manager, officer or otherwise) is normally subject to the liability of the LLC-P. Also California LLC-P's (limited liability companies taxed as partnerships) are subject to gross revenue taxes whereas LPs are not. Both family limited partnerships (FLPs) and family limited liability companies taxed as partnerships (FLLC-P's) are typically established by a member of the senior (donor) generation to accomplish continuity of management and asset protection/preservation during intergenerational transition planning. The senior generation takes control of the entity (general partner in the case of FLPs, manager(s) in the case of the LLC-P) by holding a majority of voting membership interests while the junior generation members (limited partners in the case of an FLP) hold only the non-voting membership interests (the economic interests) in the LLC-P. These economic interests (non-voting membership units or limited partnership interests) are then gifted or sold directly to heirs or to their trusts for the benefit of junior generations and, occasionally, family-controlled charities or charitable trusts.