USING LLCS TO AVOID PROBLEMS AFTER AN OWNER DIES

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WARNER CENTER ESTATE AND TAX PLANNING COUNCIL
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USING LLCS TO AVOID PROBLEMS AFTER AN OWNER DIES

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1. Intro to Limited Liability Companies[1]

2. The California Taxes on LLCs – Just Pay It

2.1. California imposes on LLCs, including single-member LLCs, a flat $800 **annual tax** and a tax on "**total income**" (that is, gross receipts) sourced in California.[2]

3. Sole Proprietor

3.1. Use a single-member LLC to prevent an executor, successor trustee or distributee from becoming an employer or subject to products liability claims.

3.1(a) The executor, trustee or distributee becomes the member and appoints the manager.

3.1(b) The executor, trustee or distributee does *not* become the employer or take title to the products.

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1 See http://www.staleylaw.com/images/LLC_Intro_36646_1.pdf.

2 Cal. Rev. & Tax. Code §§ 17941 (flat tax), 17942 (tax rates on "total income"). The current "total income" tax rates are:

Total Income	Tax
$0-$249,999	$-0-
$250,000 -$499,999	$900
$500,000 - $999,999	$2,500
$1 million - less than $5 mill.	$6,000
$5 million or more	$11,790

Texas and Pennsylvania also impose taxes on LLCs.

3.1(c) An LLC can, but usually does not, have officers like a corporation. A board of directors and/or a board of advisors are also possible, but more rare.

3.2. A single-member LLC is "disregarded" for income, estate and gift tax purposes.

3.2(a) A single-member LLC is *not* disregarded for liability purposes or for sales or property tax purposes.

3.2(b) Any LLC can be classified as a corporation for tax purposes, if the member(s) make an affirmative election, but it is rarely done and even more rarely a good idea.

3.3. The Section 1014 basis step-up is preserved for tangible and most intangible assets of the business, but probably not for goodwill.

3.4. A single-member LLC should have an operating agreement between the member and the LLC. The agreement states how a successor manager is chosen and who can sign to convey LLC assets or to undertake liabilities of the LLC.

3.5. A single-member LLC usually should be manager-managed, to avoid a situation in which, after the death of the original member, all heirs have the right to bind the LLC.

3.6. A single-member LLC is often the ideal entity for a subsidiary of a holding company or an operating company.

4. Real Property – One Owner or Owned by Husband and Wife

4.1. Use an LLC to prevent an executor, successor trustee or distributee from becoming subject to environmental liability claims.

4.1(a) The executor, trustee or distributee becomes the member of the LLC. The member(s) appoint the manager.

4.1(b) The executor, trustee or distributee does *not* appear on title to the property.

4.2. Preserves the Section 1014 basis adjustment at death.

4.3. Might provide discounts for estate and gift tax values.

4.4. Consider California property tax consequences of the transfer to the LLC.

4.4(a) The parent-child exemption does not apply to transfers of LLC or partnership interests.

4.4(b) The transfer to an LLC or other entity will not trigger a "change in ownership" IF the indirect ownership interests are exactly the same before and after the transfer.

4.4(c) If the above rule is used, then when on a cumulative basis more than 50% of the interests in the entity have been transferred, there will be a change in ownership of the entire property.

4.4(d) The above rule does not apply to property bought by the entity.

4.5. Consider the effect on title insurance held by the property owner.

5. Real Property – Several Owners

Jim, Rick and Steve, three old guys, own a parcel of commercial property. For decades they have run it just fine as tenants in common. Jim dies and his wife takes his place. That's manageable. Jim's wife dies and their three surviving kids and four adult grandchildren become tenants in common. All need to sign each lease. No longer manageable. All are subject to environmental liabilities.

5.1. If Jim, Rick and Steve get the planning itch at the exact same time, they can all put their tenants in common interests in an

LLC. The LLC would have three managers, initially Jim, Rick and Steve. The LLC would have three classes of interests – J class for Jim, R class for Rick and S class for Steve. So each family would always elect one of three managers.

5.2. If Jim gets the planning itch before Rick or Steve, Jim can transfer his tenancy in common interest into an LLC with one manager. That way, one manager will always represent Jim's family, no matter how many family members own interests in the LLC. The successors will not incur environmental liabilities because they will not be on title.

5.3. Jim gets the itch, Rick and Steve are willing to take baby steps, no more. Jim, Rick and Steve transfer their tenancy in common interests to a general partnership. Jim transfers his partnership interest to an LLC as in 5.2 above. At least there is a way to have a bank account for the property and to borrow in an entity's name. Rick and Steve can set up LLCs when they get around to it. If they don't their heirs are subject to the same liabilities as if they held tenancy in common interests.

5.4. Preserves the Section 1014 basis adjustment at death.

5.5. Might enhance valuation discounts for EGT purposes, while actually making it easier to sell the entire fee interest to one buyer.

6. Family Limited Partnership

Mon and Dad owned commercial real property for many years. Eventually, they set up a family limited partnership and transferred the property to the FLP. They gave FLP interests to the children. Mom was GP after Dad died. Junior helped her run the FLP.

Mom just died. Junior is concerned that stepping in as GP will subject him to environmental and other liabilities. "Why should I have to take on these liabilities, but not my siblings?"

The sibs did not mind when Mom and Dad had an extreme degree of control over the FLP. After all, Mom and Dad originally owned all the partnership interests and the kids did not pay anything for their LP interests. The sibs are not very happy about Junior having all of the discretion that Mom and Dad had. They would like to tighten up the agreement by reducing the GP's discretion and increasing the GP's accountability to the LPs.

6.1. It's generally a bad idea to die with an FLP holding real property that might be subject to environmental clean-up obligations.

6.2. Better to convert the LP into an LLC during the life of Mom. Then Junior can become the successor manager without taking on the unlimited liability of a GP.

6.3. The conversion from an LP to an LLC is a good opportunity to reduce the manager's discretion and to increase the manager's accountability to the members.

6.4. The conversion should be a non-event for property tax and income tax purposes. The LLC uses the same EIN as the LP did.

7. Limited Partnership with an LLC as the GP

7.1. It minimize California taxes. But the cost might be too high.

7.2. It provides limited liability ... IF it's operated properly.

7.3. A signature block that works:

STALEY PROPERTIES, LP
By its sole General Partner
STALEY MANAGEMENT LLC

By ________________________
Bill Staley, Manager

7.4. Signature blocks that could make the manager of the GP-LLC, a individual, *subject to unlimited personal liability as a general partner*:

STALEY PROPERTIES, LP

By ___________________________
Bill Staley, Manager

STALEY PROPERTIES, LP

By ___________________________
Bill Staley

____
Bill Staley for Staley Properties, LP

____
Bill Staley, Staley Properties, LP

7.5. Bottom line: It's easy to lose the liability protection of the limited partnership with an LLC (or corporation) as the sole general partner.

8. Protection from the Member's Creditors

Now Jim, Rick and Steve are three surgeons who own their medical building as tenants in common and have a lot of equity in it.

8.1. Steve loses a big malpractice lawsuit and is wiped out. His creditor takes Steve's interest in the building and tries to partition the property and force a sale, against the wishes of Jim and Rick.

8.2. IF Jim, Rick and Steve held the building in an LLC, Steve's creditor could not force a sale of the property. The creditor could only get a "charging order," instructing the managers of the LLC to redirect any distributions from Steve to his creditor until the judgment was paid. (Steve probably still owes the taxes on his share of the LLC income while the order is in place.)

8.3. It is uncertain whether charging order protection would apply to a single-member LLC or to an LLC in which all of the other members received their interests as lifetime gifts. The protection is intended to protect the other members who invested in their membership interests.

9. Keeping the LLC Property in the Family

Long ago Mom and Dad transferred to an LLC interests in their commercial properties, hedge funds and brokerage accounts. The LLC interests of their children were held by custodians until age 21. The oldest child turns 21 next month. Mom and Dad and all the children live in California.

Mom and Dad want to protect the assets from the creditors of their children.

They also want to prevent the children from transferring the LLC interests to their spouses and then having spouses take the LLC interests in divorces. They don't want a spouse to die and leave LLC interests to the spouse's family and not to Mom and Dad's descendants.

9.1. Charging order protection is probably all that can be provided for the children. A trust into which a child transferred his own LLC interest would be a self-settled trust and would not provide much creditor protection, if any – no matter which state law applies.

9.2. As the children reach age 21, they can transfer their LLC interests into a trust for the benefit of themselves and their sibs.

9.2(a) The trust would not distribute its LLC interests to the child until the child reached a set age – maybe age 40 (or maybe the LLC interests would remain in a dynasty trust for as long as possible).

9.2(b) Each adult child would be a trustee. (When there was one trustee, there would also be a trust protector.) The consent of (the trust protector or) the other trustees would be required to transfer an interest out of the trust early or to change the separate property character of an LLC interest held in the trust.

9.2(c) Ideally, if the adult children were not at the highest income tax rates, the trust would be a grantor trust.

9.3. Could the LLC operating agreement without the trust suffice to keep the LLC interests in the family?

9.3(a) A right of first refusal or options to buy interests transferred outside the family are probably OK. The values probably need to be reasonable for the provisions to be enforceable (although some have argued that a super-low value intended as a "poison pill" might be enforced).

9.3(b) Transfers of the reasonable value of the LLC interest outside the LLC might be considered by Mom and Dad as almost as bad as transferring the LLC interest itself.

9.3(c) Under a common law policy accepted in California, courts refuse to enforce "unreasonable restraints on alienation of property." It is not possible to know precisely where this line will be drawn, so it is probably best to use other techniques – like trusts -- to keep the shares in the family.

10. The Series LLC

10.1. A "series" LLC is one LLC with several internal "series" (or "cells"), each series holding assets, each series with the same or different investors.

10.2. A claim against one series cannot be enforced against the assets of another series.

10.3. Perfect for holding the family's real property assets in separate series, isolating each property from claims arising from the others and filing one tax return? Well…

10.3(a) By instructions, the California Franchise Tax Board requires a separate tax return (and $800 payment) from each series. (Some have asked how the FTB will ever know that a particular LLC is a series LLC unless the FTB looks up the Certificate of Formation.)

10.3(b) California's LLC law does not provide for series LLCs. California courts must provide "full faith and credit" to the laws of other states, so the limited liability of a series of a non-California series LLC doing business in California should be respected. No California cases on this yet.

10.3(c) If one series enters bankruptcy, the stay in bankruptcy probably applies to the LLC and all of its series. Bankruptcy law does not have special provisions for series LLCs, so the proceeding applies to the entire LLC or none of it. The series should ultimately be respected in a bankruptcy proceeding, but the other series of that LLC are on ice until the court decides to release them or until the bankruptcy proceeding ends – possibly years. This is the primary reason to avoid using series LLCs in 2011.

11. Storm on the Horizon – Carried Interest Legislation[3]

11.1. The legislation would apply to managers of all real estate deals – not just private equity group managers and hedge fund promoters.

11.2. For the LLC that they manage –

11.2(a) All non-recognition provisions are turned off for them.

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[3] See my outline *LLCs and S Corporations – An Update On Pending Legislation* at http://www.staleylaw.com/images/Carried_Interest_-_17074.pdf. It was presented on May 21 , 2010.s

11.2(b) All gain for them is ordinary income.

11.2(c) Exceptions apply for invested capital.

12. Donating Questionable Real Property to a Charity

Don Donor owns a parcel of real property that had questionable results in Phase 1 environmental testing. The lender wanted Phase 2 testing before it would committ to the loan. Don declined because if the Phase 2 tests showed contamination, Don must remediate the property, even if the remediation costs exceed the value of the proprerty.

Don offered the property to Charitable Foundation, but did not mention the Phase 1 tests.

The Foundation offered to create an LLC owned entirely by the Foundation, and Don could contribute the property to the LLC. Don declined because the LLC is not a Section 501(c)(3) organization and there is no revenue ruling saying that a charitable contribution to an single-member LLC owned by a charity is deductible.

12.1. Foundation asks Don to create a new LLC wholly-owned by Don, transfer the property into the LCC, and then transfer the LLC interest to the Foundation.

12.2. The LLC will have the clean-up liability (as will Don). But the Foundation is not on title, so has no direct clean-up liability.

12.3. The valuation of the LLC interest is between Don and the IRS. The Foundation merely acknowledges that it received the LLC interest and that the property was owned by the LLC at the time.

12.4. The Foundation might decide to have the LLC obtain title insurance, because Don’s policy will not protect the LLC.

13. Bonus from Jacob Stein:[4] DE LLC for Privacy

Jacob suggests using a Delaware LLC, especially if the LLC is not required to register with the California Secretary of State. The agent for service of process would be CT or another corporate agent. The name of the manager is not made public by the Delaware Secretary of State.

Note: If the LLC must file with the California Secretary of State because it owns property in California or is active there, it will be required to identify the manager(s) in a public document. If the LLC is not active outside of California, it is easier to use a California LLC to avoid filing in two states.

14. Bonus from Bill: A Classic "Flip"

Peter Promoter finds a great property that, with just a little work and a modest investment, can be sold for a lot more that its current price. Mo the Money Guy is willing to invest the necessary cash. They create an LLC. Peter contributes $1,000 and his option to buy the property, Mo contributes $1 million. The LLC borrows the rest of the purchase price, buys the property and takes out a construction loan to spruce it up.

14.1. Peter might or might not get a "guaranteed distribution," like a salary, from the LLC to live on during the deal.

14.2. Mo gets a "priority return," maybe 8% when the prime rate is 3.25%, on his invested capital. The priority return is paid on the invested capital.

14.3. The first distributions are paid 1% to Peter, 99% to Mo. Distributions cover the priority return until it is paid up to date. Next distributions return capital to the investors.

14.4. When Mo has his priority return all paid up and has received back all of his invested capital, the "flip" occurs. In a buy-and-sell

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4 Jacob is with the firm of Klueger & Stein, LLP www.lataxlawyers.com. I am indebted to Jacob for his comments on a draft of this outline and for this suggestion.

deal, this probably happens when the LLC sells the property and repays its loans. In a buy-and-hold deal, it might occur when the LLC refinanced the property, paid off the construction loan and distributed borrowed cash to the members.

14.5. After the flip, Mo and Peter share all distributions 50-50. (Even if there are 10 money investors, Peter would get 50%.)

14.6. Their voting interests are probably 99 votes for Mo and one vote for Peter until the flip, and then they would vote 50-50. Until the flip, Mo can remove Peter as manger, but Peter would remain a member and Peter's interest in distributions would still increase at the flip.

14.7. There are many versions, but this is the stripped down, classic flip. It is useful for projects outside of the real estate world, too.

14.8. The gain on the promoter's flip interest would be ordinary income, not capital gain, if the carried interest legislation passed.

[End of outline.]