

Leaving a Legacy

Limited Partnerships, LLCs, and Corporations

Erin M. Kiella
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Individuals with significant real estate holdings and asset portfolios desire managerial flexibility in their estate planning. They often wish to bring their heirs into the management of the estate prior to giving them full ownership of the assets. As a result, business structures such as limited or family limited partnerships, limited liability companies (LLCs), and corporations are now common in estate planning.

As with a trust (which, along with wills, is discussed in “Leaving a Legacy: Wills and Trusts” on the Real Estate Center’s website), assets transferred into limited partnerships, LLCs, or corporations are no longer owned by the individual but by the entity itself. Under those arrangements, it’s not the assets that are transferred to heirs but rather ownership interests in the entities. This strategy creates a management structure uninterrupted by a probate process and that potentially reduces one’s taxable estate. It also provides parents the opportunity to teach their heirs about the estate, hopefully ensuring a smooth transition of management when the time comes.

Maintaining and sharing records with heirs so they can become familiar with them is key. Heirs should

The Takeaway

Business structures such as limited partnerships, limited liability companies, and corporations can be useful estate-planning tools, especially when dealing with significant real estate holdings. However, each comes with different tax consequences and varying degrees of personal liability. Always consult a team of professionals before deciding on a plan.

also be exposed to regular management tasks such as negotiating and preparing leases for farming, grazing and hunting; and negotiating and documenting surface damages, easement and pipeline right of ways, appraisal districts, CRP contracts, etc. The more the heirs learn about managing the assets, the more likely they will be successful in operating them when they take full ownership.

The following scenarios illustrate the nuances of several business structures, highlighting some of the pros and cons of each.

Limited Partnerships

Phil and Martha currently own 3,500 acres of noncontiguous land. They lease several parcels to farmers and have hunting leases on multiple parcels. They keep some of their land for personal use. Currently, they lease the land through their sole proprietorship under the business name PMC Properties. Phil wants to keep the properties under a single ownership and teach his children, Jennifer and Justin, about operating the properties so they will have a complete understanding of the logistics of running the estate successfully when they inherit it.

Phil and Martha establish PMC Limited Partnership, in which they each hold 49 percent limited partner positions. They form an LLC to own the 2 percent general partner position. The general partner controls all management and investment decisions and bears 100 percent of the liability. By forming an LLC that owns the general partner position, the couple maintains personal liability protection. The couple is still liable for any tortious or negligent acts they commit in the course of operating the business. They are liable for any and all money they invest in the LLC or partnership or anything they have personally guaranteed. Additionally, if the couple holds the general partner position and both of them pass away, the partnership terminates. When this happens, the entity loses its tax benefits and management structure, which negates Phil and Martha's estate-planning needs.

Under the partnership, Phil and Martha have joint authority through their management and officer positions in the LLC, which manages the operations of the partnership. Any individual holding a general partner position acts as an agent for the partnership and can enter into legally binding arrangements on behalf of the partnership. The joint authority of the partners makes all partners liable for the decisions or wrongful acts made by any partner if committed in the normal course of the business.

The partnership agreement details the limitations of this authority. A partnership agreement, while not required for general partners, is highly recommended and extremely important for the partnership's success. Limited partnerships require limited partnership agreements. Limited partnerships must file a certificate of formation with the Texas Secretary of State. Partnership agreements outline the purpose of the business, limitations on business activities, limitations on an individual partner's authority, contributions made by partners, the timing of those contributions, and share and distribution of profits as well as losses, among other things.

Personal liability is limited for those holding limited partner positions. Limited partners usually invest in the company in some way but do not participate in daily management of assets or decision-making. The limited control of the partner grants them their limited liability. If the limited partner partakes in the management of the assets or entity, their limited liability protection can be revoked. The limited partner is still liable for any tortious acts they may commit, and they are liable to lose all they have invested in the partnership.

Given the unlikelihood of the federal estate tax affecting most people, managing the income tax faced by the owners of the assets and their heirs has taken priority. If Phil and Martha believe their estate will surpass the federal estate tax threshold, they may consider gifting some of the ownership interests to their children while Phil and Martha are still alive. Some couples do this even if they do not believe they will surpass the threshold. They gift some of the limited ownership positions to give their children a sense of ownership and responsibility for the assets. If Phil and Martha are more concerned with managing income taxes, they will make decisions based on changes in the cost basis of the assets. When an asset is sold, the owners of the asset pay taxes on the appreciation of the asset, strategically transferring ownership of assets to step up the cost basis, which can minimize the taxes their children will pay on the assets' appreciation.

Assets transferred into the partnership maintain the cost basis as the original cost of the assets. The ownership interests gifted to the children while the parents are alive maintain the cost basis of the parents' positions. If the assets are transferred when the parents die, those interests receive a step-up in basis at the time of transfer. Additionally, at the next tax return filing period, the heirs may elect for a step-up in basis for the assets held in the limited partnership. The value of the assets inside the partnership step-up in basis to match the basis of the ownership interest. When the parents transfer the majority of their assets on their death, their children minimize the taxes they would pay on the sale of the assets or ownership interest.

If Phil and Martha plan to give a small portion of ownership interest to their children now, they will have to consider the federal gift tax exclusion and the federal estate tax threshold. The federal gift exclusion allows them to give gifts valued up to \$15,000 annually to any recipient. Their tax accountant has informed them that their federal estate tax threshold will be eroded by the amount in excess of \$15,000. The couple gifts each child 5 percent limited ownership positions. The value of the

ownership interest greater than \$15,000 is deducted from their federal estate tax threshold, which is currently \$22.8 million. For example, if each of the two 5 percent ownership interests has a value of \$50,000, their federal estate tax threshold will decline by \$70,000 (\$100,000 – \$30,000) to \$22.73 million.

Because decision-making and asset control are restricted in limited partnership positions, they are valued below general ownership positions. Similarly, limited partnership shares are valued less than the market value of the assets held by the partnership. Gifting limited partnership positions allows the owners of the assets to transfer more of an asset while eroding less of their federal estate tax threshold.

Phil and Martha could have also put the limited partnership interests into a trust and made their children the beneficiaries, but they decided giving their children the limited positions directly accomplished their goals for the transfer of ownership. The limited partnership positions provide the assets similar protection from creditors as trusts do. Creditors cannot force cash distributions, vote, or own the interest of a limited partner without the consent of the general partners. Therefore, if one of Phil and Martha's children fall on hard times, the assets are protected.

Also common is the designation of a *family* limited partnership. In many family limited partnerships, the partnership agreement requires the ownership interest to remain in the possession of family members. If someone divorces, the partnership agreement can require a transfer back of ownership interest to the partnership for fair market value, keeping the asset ownership among family members.

As time progresses, Phil and Martha plan to move away from operating the assets and bring their children into the operations by giving them officer positions in the LLC. Phil and Martha will remain the sole members and managers of the LLC. The children learn the management responsibilities of the assets through their officer positions while Phil and Martha retain control of the assets.

Limited Liability Companies

Kathy and Will are friends of Phil and Martha and have a similar real estate portfolio. They own several thousand acres with both agricultural and recreational leases. They also own mineral rights they have leased out. They like the idea of transferring ownership of these assets to their children but would like some of their children to

take active management roles. Kathy and Will decide to transfer their assets into an LLC. They believe the structure and the limited personal liability of the owners accomplishes their estate-planning goals. Kathy has their attorney begin the process of filing the LLC with the Secretary of State. Their attorney also begins constructing their LLC's governing document, the company agreement. The document outlines several details Kathy and Will need to agree on for the structure of their LLC.

The couple discusses the ownership and management structure, allocation and distribution of profits, taxing and voting structure, how they will handle transfer of ownership interest, and several other smaller details. The LLC ownership structure is divided among members who own membership interests. Kathy and Will each own 50 percent. The company also has managers who act as a board of directors. Kathy and Will decide to be the LLC's sole managers, giving them control over decision-making and the hiring of officers who manage the entity's daily operations. They will also hold officer positions but decide to appoint their children to some officer roles.

LLCs can allocate profits in any manner they wish, not necessarily according to ownership interests. The couple chooses to allocate their profits in proportion to their ownership interest. Determining the allocation structure is important for determining how taxes are paid. Unless the couple elects to be taxed like a corporation (often done when the majority of profits are retained by the company), the LLC is a pass-through entity. A pass-through entity means the owners are responsible for paying the taxes on the income made by the entity. The couple decides to distribute enough profits annually to cover income taxes as well as a small amount to cover a portion of their living expenses. If they require additional income from the LLC, they will take at-will draws.

Kathy and Will considered organizing their assets as a corporation, but their attorney advised against this for several reasons. Owners of corporations have more reporting and payroll requirements and less structuring flexibility, and they are subject to double taxation when distributing profits to shareholders or when transferring assets out of the corporation. As noted, LLCs can allocate profits and losses that do not necessarily align with the ownership structure. Certain owners can also be paid before others. Tax obligations can also be allocated to a single member if, for example, one owner's real estate contribution triggers a tax obligation. In a corporation, there is no separate treatment of individuals, meaning there cannot be special allocations or special tax treatments.

In some instances, corporations are restricted by who can hold ownership positions. LLCs allow entities such as other LLCs, a corporation, or a trust to hold membership positions. S corporations do not allow entities to own shares of the corporation, and only trusts structured to own S corporation stock may own stock of an S corporation.

LLCs are more passive vehicles when it pertains to payroll. LLC owners can pay themselves a guaranteed payment, which is subject to self-employment tax but not payroll taxes. Corporations, on the other hand, do not allow guaranteed payments and are required to pay payroll taxes on any salary paid. In addition, salaries paid by a corporation are required to be of reasonable amounts, whereas the LLC does not have compensation requirements.

The biggest drawback of the corporate structure for Kathy and Will is the significant amount of real estate they are trying to manage. Corporations have two tax designations: C and S. An S corporation structures taxes similarly to an LLC, where it is a pass-through entity and the owners pay income tax on the profits made by the company. In a C corporation, the entity itself pays taxes and is subject to different tax brackets and rates. The corporate structure discussed here is a C corporation. As such, if the shareholders of the corporation decide to transfer a piece of real estate out of the entity, the transfer triggers a tax consequence. The transfer must be considered a sale, and the proceeds are subject to double taxation. The entity pays capital gains tax on the appreciation of the asset, then the shareholders pay income tax once the asset is transferred as it is considered a dividend distribution or liquidating distribution.

In addition to the double taxation, corporations do not have favorable capital gains tax rates. The couple would be subject to double taxation if they distribute any of the entity's income to shareholders through dividends. Kathy and Will would like to take distributions as needed. In a corporate structure, distributions are made through dividend payments. Distributing profits to shareholders through dividends is subject to double taxation. The corporation pays corporate taxes on its income, and Kathy and Will pay income taxes on the dividend distribution. Given these characteristics of corporations, Kathy and Will decide the LLC structure makes the most sense for their estate-planning goals.

After registering the LLC with the Secretary of State and developing and signing the company agreement, Kathy and Will transfer their assets into the LLC. They are no

longer the owners of the assets, but they hold ownership positions in the LLC that now owns the assets. The limited liability of the company ensures only the assets transferred into the company are at risk to the claims and obligations of the company. Kathy and Will can lose only what they have invested and transferred into the company. The assets they do not transfer into the LLC, such as their savings and home, are not liable to the claims against the LLC. On the other hand, if Kathy and Will act negligently while working on behalf of the LLC, they will be held personally liable for their actions.

Kathy and Will plan to remain the managers of the LLC indefinitely. They choose to retain their membership interests in the company and transfer them on their death rather than before so their children benefit from the step-up in basis. The couple worked with their accountant and financial planners to estimate their taxable estate, its expected growth rate, and how any proposed gifts would affect their federal estate tax threshold. They believe they will not be affected by the threshold. They believe that the LLC strategy will teach their children about the operation of the assets and minimize their heirs' tax obligations.

Corporations

Paige and Michael have a portfolio of assets they own through an LLC. They would like to separate the liability of operating those assets from the assets themselves. Their attorney recommends setting up a corporation to run and manage the operations. The corporation rents the assets from the LLC for the operations. Paige and Michael's lawyer informs them that, like an LLC, a corporation is a legal entity separate from its owners and managers.

The corporate structure gives Paige and Michael a "corporate shield" that limits their personal liability. Their personal assets and the assets owned by their LLC are protected from the liabilities of the corporation. Therefore, Paige and Michael stand to lose only what they have invested in the corporation. Their lawyer informs them that the corporate shield can be lost if they do not follow the requirements of a corporate structure (for example, holding shareholder and director meetings, maintaining corporate records, and documenting major corporate decisions). They will lose the limited liability protection if they treat the corporation as an extension of their personal affairs rather than as a separate legal entity.

A certification of formation is filed with the Secretary of State. Paige and Michael then create a set of bylaws

to govern the corporation. They will be the sole owners, which are referred to as shareholders in a corporation. As shareholders, they approve the sale of any major corporate assets, and they elect and remove directors who serve on the company's board. Paige and Michael decide to serve as the sole directors of the corporation's board of directors. As directors, they authorize the issuance of stock; elect officers; set salaries; mortgage, sell, or lease real estate owned by the corporation; and approve loans. Until they decide their children are ready to take on more managerial roles, Paige and Michael will be the only officers for the daily management of the company.

The couple's attorney informs them of potential tax designations for a corporation—a C corporation and an S corporation. He emphasizes that the designation changes only how taxes are paid; it does not change the structure of the entity. For a C corporation designation, the entity itself pays taxes on the profits and losses of the company at the corporate tax rate. The C corporation designation is subject to double taxation if it distributes profits to shareholders through dividends. In an S corporation designation, the taxes are passed through to the owners similar to the tax structures of an LLC or limited partnership. The couple would choose an S corporation if they planned to retain profits in the company and would like to avoid the C corporation's double taxation issues.

Paige and Michael choose the C corporation structure to manage the payroll of their staff and the expenses associated with the operation. The couple does not intend for the corporation to own any assets or distribute profits to shareholders through dividends, thereby avoiding concerns about double taxation. They will set a lease rate for their assets such that the profits associated with the assets are transferred to the LLC. The salaries and bonuses paid to employees, interest payments on loans, rent payment, fringe benefits, and the cost of annual director and shareholder meetings are tax-deductible for the corporation. To avoid additional payroll and benefit liabilities, the couple will not take a salary from the

corporate entity. They will work with their attorney to set up the corporate structure and the lease agreements to lease use of their assets in the LLC, protecting their assets from the operational liabilities occurring in the corporation.

Assembling a Succession-Planning Team

When considering any succession strategy, always consult with a team of experts to ensure the best decision is made for the assets owned and circumstances involved. An attorney can recommend legal strategies and tools to reach personal and financial goals. They will describe the options available and their implications. They will also be instrumental in forming the legal ownership and developing the necessary documents for the structure chosen.

A certified financial planner will help you understand your current financial position, set goals for the future, and outline what is necessary to achieve those goals through investment, income, and retirement planning. They will determine, from a financial standpoint, given your management and income needs, what estate-planning tool will achieve your goals and minimize tax burdens. A tax attorney or certified public accountant determines the amount and types of taxes your estate may face given the estate-planning strategy chosen.

Finally, an appraiser will be vital in determining the market value of your assets, especially when significant real estate is involved. Anytime ownership interest or assets are transferred, the value transferred must be at fair market value. An appraiser may be required to determine the fair market value of the asset transferred for tax purposes. ➡

Dr. Kiella (ekiella@mays.tamu.edu) is an assistant research economist with the Real Estate Center at Texas A&M University. Special thanks to Thomas C. Baird of Baird, Crews, Schiller & Whitakers, P.C. for his contributions to this article.