

# YOUR HEIRS MAY FIND YOUR SINGLE MEMBER LLC TAXING

By

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## I. SMLLC Scenario and Potential Consequences

Archie and Edith were married for 50 years. After Archie's death, Edith sold their home in Queens, New York for a tidy profit. Archie also named his wife as the beneficiary of a large insurance policy he bought when he first started working at the loading dock. Edith's financial advisor recommended that she invest the gain from the sale of her home along with the insurance proceeds in a Manhattan duplex. Edith wasn't interested in staying in New York, so about five years ago she moved to Arlington, Virginia to be closer to cousins on Archie's side of the family. The duplex is currently owned by a New York single member limited liability company ("SMLLC"). Gloria and Mike, her daughter and son-in-law, live in one of the property's units, and her grandson, Joey, lives in the other. Each family pays rent to the SMLLC for its unit. The current value of the duplex is \$6.5 million.

Edith was advised to create the SMLLC to avoid ancillary probate and New York state estate tax. Unfortunately, the SMLLC may not accomplish either of those purposes. Edith is looking at her estate plan again and wants to know what will happen to the SMLLC at her death.

This SMLLC may create costly and unintended consequences for Edith's estate. Depending on the duplex's value, there may be a New York State (NYS) estate tax liability. Even if no estate tax is due, the estate may still have to file a NYS estate tax return. This is a complex task which raises the cost of estate administration and could have been avoided. Furthermore, filing the NYS estate tax return requires submission of information to New York tax authorities that may trigger inquiries into Edith's residency status. Ancillary probate may be required if the death of Edith as the sole member causes the dissolution of the LLC. This also adds to the burden of estate administration, both increasing time and cost.

This article will: (i) review taxation of limited liability companies at the federal and state levels; (ii) address treatment of a SMLLC for nonresident New York estate tax purposes; (iii) discuss ancillary probate and estate administration; and (iv) offer potential solutions to minimize potential state estate tax liability and burdens of estate administration.

## II. Tax Liability and Estate Administration

How the LLC is treated for income tax purposes during Edith's lifetime will affect its treatment after her death and create certain consequences for Edith's estate relating to the real property held in the LLC.

***Tax Treatment of LLCs:*** A limited liability company with two or more members is treated as a partnership for federal tax purposes,<sup>1</sup> unless it has elected corporate status by checking the box on Form 8832, Entity Classification Election. Because Edith did not make this election, her single member LLC is disregarded as an entity separate from its owner, like a sole proprietorship. A LLC treated as a partnership or a disregarded entity does not pay any income taxes, but instead all

income and loss is taxed directly to the owner.<sup>2</sup> An entity that has elected to be treated as a corporation will pay tax at the entity and shareholder level (as discussed further in Section III). Under New York law, Edith's LLC will be treated for state income tax purposes in the same manner as it is treated for federal income tax purposes.<sup>3</sup>

For estate tax purposes, Edith's LLC interest will be part of her federal taxable estate. Note that the Commonwealth of Virginia has no state estate tax.<sup>4</sup> On her death, the real property held in the LLC will receive a stepped-up basis.<sup>5</sup>

***SMLLC and Real Property:*** New York state estate tax may be due, as though Edith owned the property outright. The New York State Department of Taxation and Finance has ruled in several Advisory Opinions that a decedent's membership interest in a New York SMLLC holding a New York residence is treated as real property, not intangible personal property, for purposes of determining a nonresident's potential state estate tax liability. This is because New York law treats an entity with a single owner, such as a SMLLC, as a disregarded entity and not separate from its owner, unless the entity has elected to be classified as a corporation for income tax purposes.<sup>6</sup>

***NYS Estate Tax on Nonresident:*** New York law imposes estate tax on real property or personal property with a New York situs that is owned by a nonresident decedent.<sup>7</sup> The estate of a nonresident individual must file a NYS estate tax return if the estate includes real or tangible personal property having an actual location in New York State and the federal gross estate (plus any taxable gifts made while the individual was a resident of the state) exceeds the New York State basic exclusion amount ("BEA").<sup>8</sup>

For the estate of a nonresident decedent who dies on or after April 1, 2017, and on or before December 31, 2018, the BEA is \$5,250,000.<sup>9</sup> If the value of the estate asset included is equal to or less than the BEA, then no estate tax is due. For property valued at up to 5.0% above the exemption, estate tax is calculated on the amount in excess of the BEA. Once the property's value exceeds 105% of the BEA, that is, \$5,512,500, then estate tax is imposed on the first dollar of assets.<sup>10</sup>

For Edith's duplex valued at \$6,500,000, New York estate tax could reach as high as \$574,000, determined as follows: tax on assets over \$6.1 million up to \$7.1 million is \$522,800, plus 12.8% of the amount over \$6.1 million (12.8% times \$400,000 = \$51,200) is added to the \$522,800, to equal \$574,000. This calculation assumes no deductions of expenses.

Even if Edith's duplex was valued at less than the New York exemption amount, it is possible that the gross value of her estate would require the filing of a nonresident NYS estate tax return, as described above. When a nonresident return is filed, a domicile affidavit for the decedent is also required. Filing these forms presents two issues.

***Requirements for Filing NYS Return:*** Form ET-706, the NYS Estate Tax Return, requires a complex re-jiggering of the federal Form 706, breaking federal deductions into four categories: (i) those directly attributable to New York property; (ii) those directly attributable to non-New York property; (iii) those attributable to intangible property; and (iv) those not directly attributable to property inside or outside New York.<sup>11</sup> Furthermore, for any deductions for property located outside New York state, a statement must be attached indicating the item number of the property listed on Schedule B of Form 706 to which the deduction is directly related, if the location of the deduction is

not clearly labeled on Form 706 Schedules J through O. These are tasks that would not be part of the routine preparation of a Form 706. The NYS return also requires the submission of a complete Form 706, with all schedules and attachments.<sup>12</sup>

***Disclosures About Decedent:*** The New York State Estate Tax Domicile Affidavit, Form ET-141, discloses a lot of information to state authorities. Form ET-141 requests details such as: (i) whether the decedent conducted any business in NY during five years prior to death; (ii) whether the decedent lived in New York state and for what time periods and the address of any New York property she owned during any period of time; (iii) where the decedent lived during the five year period prior to death, the time period for each residence, and the address and ownership status of each residence; and (iv) where the decedent filed federal and state income tax returns for the last five years, including the address of the IRS Service Center.

These requirements would add to the costs of administering Edith's estate. Furthermore, the required disclosures could trigger inquiries from the New York State Department of Taxation and Finance into Edith's residential status at death.

### **III. Solutions to Avoid State Estate Tax**

***Admission of New Member:*** Edith could transfer a small interest in the entity to Gloria now and admit her as a new member. The LLC would then no longer be a single member LLC. For federal income tax purposes, it would be considered a partnership, with all income and loss taxed directly to Edith and Gloria in proportion to their interests.<sup>13</sup> For state estate tax purposes, the entity would not be disregarded, and on Edith's death, her LLC interest would pass to her estate as intangible personal property,<sup>14</sup> not as an ownership interest in real property.

Another option would be to contribute an LLC interest to an irrevocable trust Edith had previously set up to make gifts to benefit Gloria and her descendants.

***Election of Corporate Status:*** Alternatively, the SMLLC could elect now to be treated as a corporation.<sup>15</sup> A retroactive election after Edith's death cannot be made. The election in place at the date of death "is the election that will be used to determine whether property owned by a SMLLC is treated as real property or intangible property for purposes of NYS estate taxes." This is because "there is no provision in New York State law applicable to the estate tax that provides for retroactively changing an election . . . post mortem."<sup>16</sup>

It is important to understand Edith's goals and objectives, that is whether she wants the property to be sold after her death and the proceeds distributed to Gloria and Mike and their son, Joey, or if she wants the property to pass to them for their use as a residence. This is because electing corporation status presents certain income tax consequences. If the real property has appreciated in value during Edith's lifetime and is later sold by her heirs following her death, the gain will be taxed. By having the SMLLC elect C-corp tax treatment, there will be a step-up in the estate's outside basis in the SMLLC shares, but no step-up in inside basis for the real property within the C-corp.<sup>17</sup> Here are the consequences:

- Corporate level tax: When the appreciated property is sold, the corporation will pay federal and state income tax on the gain. The federal rate is 34% on any amount in excess of \$75,000 and up to \$10,000,000.<sup>18</sup> Unlike for individuals, no preferential rate applies to the

long-term capital gain on an asset held by a C-corporation.<sup>19</sup> The New York corporate income tax rate is 6.5%, beginning with the first dollar of taxable income.<sup>20</sup> Federal taxable income may be reduced by the amount of state income taxes paid, but such taxes must have been paid during the calendar year when the income is triggered.<sup>21</sup> Therefore, the corporation must pay estimated state income taxes and not wait to pay the state taxes when the state income tax return is filed after the close of the tax year.

- Shareholder level tax: When the sales proceeds are distributed, a portion of the distribution (essentially equal to the capital gain reduced by the tax paid) will be taxable to the recipient as an ordinary dividend. A shareholder will recognize gain equal to the difference between the amount realized and his/her basis in the stock.<sup>22</sup>
- Possible capital loss for shareholder: If the total liquidation proceeds are less than the date of death value of the corporation, the owner will receive a capital loss. A capital loss may only be used to offset capital gains. If losses exceed capital gains, any excess may be used to offset up to \$3,000 per year of ordinary income.<sup>23</sup>

#### IV. Consequences Related to Probate and Estate Administration

***Dissolution of LLC on Member's Death:*** The goal of avoiding probate is complicated by whether the SMLLC is subject to dissolution. This may occur when the LLC agreement (i) is silent about what happens to the sole member's interest when she dies and (ii) authorizes dissolution in accordance with the New York LLC Act. Under New York Limited Liability Company Law § 701(a)(4), an LLC is dissolved when no members are left, unless the LLC agreement provides otherwise. If the entity ceases to exist, then it is reasonable to conclude that the entity's assets would be deemed to be owned outright by the decedent.

***Requirement of Ancillary Probate:*** There are different views as to whether the SMLLC interest could continue to be treated as intangible personal property for probate purposes, or if instead, ancillary probate would be required.

Some commentators<sup>24</sup> state that the statutory origins of the entity require an interest in a LLC to be viewed as personal property:

In every LLC jurisdiction, regardless of the real or personal property owned by the LLC, the subject member's LLC is by statutory fiat, a personal property interest. As a consequence, a person who is the sole member of a LLC that holds only real estate in an ancillary jurisdiction, has only a personal property interest in the LLC. There is, therefore, no ancillary probate of the foreign real estate holdings.

A recent law review article<sup>25</sup> presents a contrasting view:

Cunningham and Proctor, for example, in their seminal LLC treatise, recognize the myriad of problems [sic] that arise when an individual serves as the single member. They note that, at death, the LLC will have no member, perhaps causing the LLC to cease to exist as an entity; the business assets will pass under probate; and the probate process may freeze management over the business.

***Substitution of Executor to Continue LLC:*** The New York LLC Act provides a solution to prevent dissolution of the SMLLC on the sole member's death, by permitting the executor of the decedent's estate to become a member in place of the decedent:

[T]he 1999 Amendments [to the New York LLC Act] clarify that an LLC will dissolve at any time when there are no members thereof (a result not articulated, but probably assumed, under the old NYLLCL, based on the definition of an LLC as having at least one member), but go on to provide that, for LLCs formed after the effective date of the 1999 Amendments, as well as other LLCs that have elected to be governed by those amendments, not even the death, dissolution or other dissociation of the last member need dissolve the LLC. In such a case, the legal representative of that last remaining member may, within 180 days after the dissociation, or such other period set forth in the operating agreement, agree in writing to continue the LLC and to admit himself or his assignee as a member, effective as of the date of the dissociation. If he does, the LLC is not dissolved.<sup>26</sup>

Therefore, the dissolution issue may be fixed after death. Even if the LLC agreement is silent on admitting new members, an executor may become a member in place of the decedent. Note that the agreement to continue the LLC and admit the executor must be completed no later than 180 days after the decedent's death.<sup>27</sup>

## **V. Final Thoughts**

As an owner of investment property, Edith may have decided to form a single member LLC for several reasons. The SMLLC limits her personal liability with respect to rental property. If Mike, Gloria, Joey, or one of their guests is injured on the premises and files suit, recourse is limited to the LLC's assets and Edith's personal assets are not in jeopardy. Another advantage is that the LLC avoids taxation at the entity level. The SMLLC's income and capital gains pass through directly to Edith, who pays taxes on her individual income tax return.

Holding her property in the SMLLC may be a good strategy for Edith to achieve her financial goals during her lifetime. Nonetheless, Edith may find the potential imposition of New York estate tax and possible probate consequences at odds with her objectives for her estate. Therefore, a property owner like Edith who has formed a SMLLC or who is considering creating one, particularly when the entity will own real property in another state, should consult a qualified practitioner to review issues that may adversely affect her estate.

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## ENDNOTES

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<sup>1</sup> See Sections 761(a) and 7701(a)(2) of the Internal Revenue Code (the “Code”). See Bishop & Kleinberger: Limited Liability Companies: Tax and Business Law, Chapter 4: Entity Comparison: Limited Liability Company Versus S Corporation, ¶4.05. Taxability of Entity.

<sup>2</sup> See Section 701 of the Code.

<sup>3</sup> N.Y. Tax Law § 601(f).

<sup>4</sup> Effective July 1, 2007.

<sup>5</sup> For a decedent who owns an interest in an LLC with multiple members, an election is made under Section 754 of the Code to adjust the basis of property owned by the entity. According to Cornelia R. Tenney and Thomas H. Belknap, *Postmortem Planning for Interests in Pass-Through Entities*, Estate Planning Journal, Jul 2000, when a member of an LLC with two or more members dies owning an interest in such LLC,

Section 754 permits a partnership to elect to adjust the basis of the decedent’s proportionate share of the partnership assets. The result of the adjustment is that the partnership’s basis in the decedent’s share of the partnership assets will be equal to the estate’s basis in its partnership interest. As a result, if the partnership sold the assets immediately after the death of the deceased partner, no gain or loss would flow through to the partner’s estate.

<sup>6</sup> See TSB-A-16(3)M, Advisory Opinion, New York State Department of Taxation and Finance Office of Counsel, August 26, 2016.

<sup>7</sup> N.Y. Tax Law § 960(a).

<sup>8</sup> See Instructions to Form ET-706, New York State Estate Tax Return (4/17) (“ET-706 Instructions”), page 1.

<sup>9</sup> See <https://www.tax.ny.gov/pit/estate/etidx.htm>.

<sup>10</sup> See ET-706 Instructions, Line 3, Applicable Credit, page 4.

<sup>11</sup> Form ET-706, Schedule E, Part 2, Computation of allowable New York State deductions for Nonresidents.

<sup>12</sup> See ET-706 Instructions, Supplemental Documents, page 2.

<sup>13</sup> Section 701 of the Code.

<sup>14</sup> A nonresident’s intangible personal property, even if located in New York State, is not subject to NY state estate tax. See N.Y. Const. Art. 16, § 3; NY Tax Law § 960(b).

<sup>15</sup> See TSB-A-15(1)M, Advisory Opinion, New York State Department of Taxation and Finance Office of Counsel, May 29, 2015.

<sup>16</sup> TSB-A-16(3)M, *supra* note 1.

<sup>17</sup> Unlike property owned by individuals, which receives a step-up in basis at death. Section 1014(a)(1) of the Code.

<sup>18</sup> Section 11(b)(1)(C) of the Code.

<sup>19</sup> Bruce D. Bernard and Christopher E. Axene, *The Taxing Problem of Real Estate in a Corporation*, Practical Tax Strategies, Feb 2005.

<sup>20</sup> NY Tax Law § 210(1)(a). The NY corporate tax rate was reduced from 7.1%, for taxable years beginning on or after January 1, 2016.

<sup>21</sup> [https://www.irs.gov/publications/p17/ch22.html#en\\_US\\_2016\\_publink1000173143](https://www.irs.gov/publications/p17/ch22.html#en_US_2016_publink1000173143).

<sup>22</sup> Bernard and Axene, *supra* note 19.

<sup>23</sup> Section 1211(b) of the Code.

<sup>24</sup> See Phillip Jelsma and Pamela Everett Nolcamper, *The Limited Liability Company*, § 9.220 Ancillary Probate and LLCs. See also Mark A. Sargent and Walter D. Schwidetzky, *Limited Liability Company Handbook* § 3:92, September 2016 Update.

<sup>25</sup> See F. Philip Manns, Jr. and Timothy M. Todd, *Issues Arising Upon the Death of the Sole Member of a Single-Member LLC*, 99 Marq. L. Rev. 725, 738 (Spring 2016). According to Stuart Levine and Fred T. Witt, Jr., *One Member LLCs: Planning With Little Boxes*, SE30 ALI-ABA 437, 444 (October 7, 1999), if dissolution of an LLC can be prevented at death, real property in the LLC would be deemed to be personal property of the decedent and thus there would be no need for ancillary probate. Note that the Levine-Witt article is not specific to New York law.

<sup>26</sup> 1 N.Y. Prac., *New York Limited Liability Companies and Partnerships* § 8:2.

<sup>27</sup> NY Limited Liability Company Law § 701(b).

