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SINGLE MEMBER LLC – A PROPERTY INTEREST OR AN INTANGIBLE

I. Massachusetts Limited Liability Companies - Background

Limited liability companies clearly are the entity of choice, particularly in cases where holding real estate is involved.

Massachusetts first introduced limited liability companies on November 28, 1995 to be effective as of January 1, 1996. St. 1995, c. 281, § 18. There were a number of problems with the statute as originally enacted including the inability to have a single member LLC and so it was amended on March 5, 2003, retroactive to January 1, 2003. St. 2003, c. 4, § 33. As a result of the 2003 amendment, single member LLCs are now permissible in Massachusetts. G.L. c. 156C, § 2

Since Massachusetts did not allow for single member LLCs until 2003, between 1996 and 2003, LLCs were formed with one or more additional members—usually with such members having a very small percentage interest (as little as one-tenth of one percent in some cases). This meant that the LLC was treated as a partnership for income tax purposes, unless it elected to be treated as a C corporation. See Treas. Reg. § 301.7701-1.

Single member and multi-member LLCs are clearly superior to other entity choices, particularly in the case of real estate holdings. For example, contributions of appreciated property to limited liability companies are income tax free. I.R.C. § 721. More importantly, distributions of appreciated property from an LLC to its owners is generally income tax free (unless there is debt associated with it). I.R.C. § 731.

This is a particularly significant benefit, inasmuch as a distribution of appreciated property from an S corporation will be a taxable event. The transfer of appreciated property to the shareholder is considered a deemed sale and there will be a capital gain recognized to the extent that the fair market value of the property distributed exceeds the basis of the property to the entity. I.R.C. § 311(b).

II. Massachusetts Business Trusts or So-Called “Realty Trusts”

Prior to Massachusetts's authorization of LLCs in 1995, many real estate properties were acquired in a Massachusetts business trust, also known as a trust with transferable shares. G.L. c. 182, § 1

For federal income tax purposes, prior to so-called "check-the-box" regulations, the Massachusetts business trust was taxed as a corporation. As a result, the Massachusetts business trust would typically make an S election to be taxed as an S corporation for federal income tax purposes, but would be taxed as a Massachusetts business trust under state law. G.L. c. 62C, § 51.

Under state income tax law, the income of a Massachusetts business trust was taxed at the regular individual income tax rate of 5%, and there was no divided tax on distributions. In essence, the income was taxed like an S corporation, even though Massachusetts did not recognize S corporations at the time. The big difference between the Massachusetts business trust, which is taxed like an S corporation, and an LLC is that the distribution of appreciated property from the Massachusetts business trust would be a taxable event, since it is taxed as a corporation for federal income tax purposes. See I.R.C. § 311(b).

This severely limited the ability of a Massachusetts business trust (or an S corporation) to dissolve tax effectively and placed a significant limitation on like-kind exchanges where one owner would like to withdraw and pay the tax and the other who would like to defer the tax under I.R.C. § 1031. Limited liability companies provide greater flexibility in that the distribution of the LLC to members is generally income tax free.

One word of caution. Many properties owned by Massachusetts business trusts are typically known as being owned by a “realty trust” and care needs to be undertaken to determine whether the entity is a Massachusetts business trust or a so-called Massachusetts nominee trust. The Massachusetts nominee trust is essentially an agency relationship so that a distribution of property from a nominee trust (also known as a realty trust) to the beneficiaries would be income tax free. On the other hand, an inadvertent distribution of property from a Massachusetts business trust (also known as a realty trust) to the shareholders would be a taxable event. See *Apahouser Lock & Security Corp. v. Carvelli*, 26 Mass. App. Ct. 385 (1998).

This is why so many properties which were acquired by a Massachusetts business trust remains in such trusts at this time, even though the LLC would be a much more flexible entity of choice. Conversion to an LLC is an expensive proposition.

III. Limited Liability

By statute, each member of an LLC has limited liability. This is the case whether it is a single member LLC or a multi-member LLC. G.L. c. 156C, § 2.

IV. Income Tax Filings

A single member LLC does not file a separate income tax return. Rather, all items of income, expenses, deductions, and credit are reported to the owner on the individual income tax return for both federal and state purposes. This often is misunderstood and has been thought to undermine the asset protection benefit inasmuch as no separate income tax filing is required to be filed. This, however, is not the case and there is no case that so holds. See Treas. Reg. § 301.7701-2(c)(2).

V. Multiple Properties

In cases in which there are multiple properties, it is common to form a parent LLC and have each of the separate properties owned by a separate LLC. Each separate title-holding LLC will be owned by the parent LLC. The separate LLCs which own separate properties are single

member LLCs that do not have a separate income tax filing obligation. Each LLC is required to pay the \$500 annual filing fee.

VI. Filing Obligation

All income will be reported on the parent LLC and, in such a case, if the parent LLC is a single member LLC, all items of income, expense, deduction, and credit will be reported on the individual's own personal income tax return. If the parent LLC is a multi-member LLC, it will be considered a partnership and all items of income, expense, deduction, and credit attributable to the subsidiaries will be reported on its tax return.

Multi-member LLCs are treated as partnerships. No income taxes are paid at the entity level. All items of income, expense, deduction and credit will pass through to the members and will be taxed in accordance with the partnership rules of Subchapter K of the Internal Revenue Code.

VII. Conversion of Single Member LLC to Multi-Member LLC

Single member LLCs often will be converted to multi-member LLCs when a membership interest is transferred by the single owner to another entity or person. In such a case, a partnership is created. For income tax purposes, thereafter a partnership income tax return must be filed whether or not income is realized. The failure to file a partnership income tax return carries a penalty of \$195 per month per member up to twelve months, regardless of income. See I.R.C. § 6698.

VIII. Gifting of LLC Membership Interests – *Pierre v. Commissioner*, 133 T.C. 2 (2009)

LLCs are used extensively for estate planning. In a typical case, a senior family member will form an LLC and contribute substantial real estate holdings to it. Thereafter, the senior family member will transfer by gift LLC membership interests. These may be voting or nonvoting and could represent a small or significant portion of the LLC using non-voting shares.

To the extent that the membership interest transferred is either a minority interest or non-voting shares, the gift tax value of the interest will be discounted. This is because the interest is nonvoting and nontransferable.

In *Lappo v. Commissioner*, T.C. Memo 2003-258, discounts of 24% for lack of marketability and 15% for a minority interest were allowed in the case of an LLC holding primarily real estate. In *Peracchio v. Commissioner*, T.C. Memo 2003-280, discounts of 25% for lack of marketability and 6% for a minority interest were allowed in the case of an LLC owning cash and marketable securities.

The computation would work as follows: Assume the LLC is formed with \$10,000,000 worth of real estate. If 49% of the LLC membership interest is transferred, the gift tax value of the transfer would be computed as follows:

Undiscounted Value:	\$10,000,000 x 49% =	\$4,900,000
Less Discount:	(\$4,900,000 x 35%) =	<u>(\$1,715,000)</u>
Gift Tax Value:		\$3,185,000

In the case of *Pierre v. Commissioner*, 133 T.C. 2 (2009), the IRS argued unsuccessfully that the LLC should be disregarded and that the transfer of a membership interest was essentially a distribution of the underlying asset to the transferor, a gift by the transferor to the transferee with a recontribution of that asset by the transferee and, as a result, no discount would be allowed. This was rejected by the Tax Court.

IX. Changing Domicile

Limited liability companies also are useful to minimize Massachusetts estate taxes in connection with a change in domicile. Massachusetts residents are subject to an estate tax that can be as high as 16%. For this reason, many Massachusetts residents consider changing their domicile to Florida, New Hampshire, or some other state that does not have a state death tax.

Aside from the need to comply with the various regulations in terms of changing voting registration, driver's license, physicians, and the like, it also is important to deal with Massachusetts real estate that the taxpayer may own. The reason for this is that nonresidents are subject to the Massachusetts estate tax based upon a formula.

The computation involves first computing the amount of the state death tax that otherwise would be due if the Florida resident was a Massachusetts resident and then multiplying that amount by a fraction, the numerator of which is Massachusetts real estate and other tangible personal property located in Massachusetts with the denominator being the decedent's adjusted gross estate. G.L. c. 65C, § 4(g).

If we assume that a single taxpayer dies with an estate of \$5,000,000, which would be nontaxable to a Florida resident, and we assume that 50% of the property is Massachusetts real estate, the Commonwealth of Massachusetts would be entitled to \$195,800, computed as follows:

Total tax due assuming decedent was		<u>\$2,500,000</u>
a Massachusetts resident:	\$391,600 x	\$5,000,000 = \$195,800

If the Massachusetts property was transferred to an LLC in connection with a change in domicile and even if the LLC is owned by the Florida resident, the numerator would be zero since the LLC is an intangible and not real estate. See *Estate of Nielson v. Commissioner*, Docket No. F232365; (Appellate Tax Bd. Feb. 15, 2001) (stating that partnership interest not taxable, but interest in realty trust taxable for Massachusetts estate tax purposes).

This planning opportunity has been addressed by a number of states including most recently New York. In an advisory opinion, the New York State Department of Taxation and

Finance issued the following Advisory opinion and concluded that real estate owned by a single member LLC will not be considered an intangible unless it elects to be taxed as a corporation:

The Department of Taxation and Finance received a Petition for Advisory Opinion from "Petitioner". Petitioner asks whether a membership interest in a single-member LLC (SMLLC), which is disregarded for income tax purposes, is "intangible property" for New York State estate tax purposes.

We conclude that a membership interest in a SMLLC owning New York real property, which is disregarded for income tax purposes, is not treated as "intangible property" for purposes of New York State estate tax purposes. However, where a SMLLC makes an election to be treated as a corporation pursuant to Treasury Regulations § 301.7701-3(c), rather than being treated as a disregarded entity, such ownership interest would be considered intangible property for New York State estate tax purposes.

Facts

Petitioner, an individual residing in New York State, is considering forming a SMLLC under Delaware law for the sole purpose of contributing his condominium, located in New York State, to the LLC and then moving to another state. He intends to remain as the sole owner of that LLC for the remainder of his life and to reside outside of New York State until his death. The Petitioner's question presumes that the proposed SMLLC would be disregarded for income tax purposes. As such, this proposed SMLLC would not be treated as a corporation under Treasury Regulations § 301.7701-3(c).

Analysis

An estate tax is imposed on the transfer by the estate of a non-resident decedent of real property and tangible personal property where such property is physically located in New York State. N.Y. Tax Law § 960 (a). Condominiums constitute real property and as such are generally subject to New York State estate tax. Real Property Law § 339-g. However, where real property, including condominiums, is held by a corporation, partnership or trust, interest in such entity has been held to constitute intangible property. See *Estate of Havemeyer* 17 N.Y.2d 216, (1966) and *In the Matter of Finkelstein*, 40 Misc.2d 910, (Surr. Ct. Rockland County 1963). Similarly, Tax Law § 951-a(c) defines "tangible personal property" to exclude the following items: bank deposits, mortgages, debts receivables, shares of stock, bonds, notes, credits, evidences of an interest in property, evidences of debt, or legal claim generally and as such, those items are deemed intangible property.

The New York State Constitution prohibits the imposition of an estate tax on a nonresident's intangible property, even if such property is located in New York State. (N.Y. Const. Art. 16). Moneys, credits, securities and other intangible personal property within the state, that are not used in carrying on any business within the state by the owner, are considered to be located at the domicile of the

owner for purposes of taxation. N.Y. Const. Art. 16 § 3. NY Tax Law § 960 likewise indicates that a NY taxable estate does not include the value of any intangible personal property otherwise includible in the deceased individual's NY gross estate.

Pursuant to 26 CFR §§ 301.7701-2, an entity that has a single owner is recognized as an entity or can be disregarded. "A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." 26 C.F.R. § 301.7701-2(a). As such, pursuant to 26 C.F.R. § 301.7701-3(a), an entity with a single owner, such as a SMLLC, is disregarded as an entity separate from its owner unless it elects to be classified as an association and so a qualifying SMLLC can elect to be classified as an association and thus treated as a corporation by making an entity classification election with the IRS. 26 C.F.R. § 301.7701-3(c)(1)(i).

Where no election is filed, the default classification of the SMLLC is that the entity is disregarded and is not deemed to be an entity separate from its owner. 26 C.F.R. § 301.7701-3(b)(ii); 6611, Ltd. v. C.I.R., 2013, 2013 WL 560866 . "An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant)... until the entity makes an election to change that classification". 26 C.F.R. § 301.7701-3(a).

Based on the above analysis, where a SMLLC is disregarded for Federal income tax purposes, it is treated as owned by the individual owner and the activities of the SMLLC are treated as activities of the owner. Therefore, under the circumstances described by the Petitioner, interest in the SMLLC owned by Petitioner would not be treated for estate tax purposes as an intangible asset. Instead, the condominium held by the SMLLC would be treated as real property held by the Petitioner for New York State estate tax purposes.

DATED: May 29, 2015

/S/
DEBORAH R. LIEBMAN
Deputy Counsel

NOTE: An Advisory Opinion is issued at the request of a person or entity. It is limited to the facts set forth therein and is binding on the Department only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. An Advisory Opinion is based on the law, regulations, and Department policies in effect as of the date the Opinion is issued or for the specific time period at issue in the Opinion. The information provided in this document does not cover every situation and is not intended to replace the law or change its meaning.

It is likely that other states will follow suit but not likely in Massachusetts because the LLC statute provides that an LLC interest is personal property and a member has no interest in specific LLC property. G.L. c. 156C, § 38. Also, this issue was addressed in a DOR regulation, 830 Code Mass. Regs § 65C.2.1, which was repealed in its entirety as being obsolete in November 2014.

X. Avoiding Stamp Taxes

General Laws c. 64D, § 1, imposes a stamp/excise tax on the sale of real estate; the amount is \$4.56 per \$1,000 of sale price and is payable by the seller. Massachusetts has not taken the position that a single member LLC is a property interest, at least for purposes of imposing the \$4.56 per \$1,000 stamp tax. In theory, then, this would permit a taxpayer to transfer their property to a single member LLC and then sell the membership interest to avoid paying the \$4.56 per \$1,000. See DOR Directive 95-5 (a sale of benefits interest in a Massachusetts nominee trust is subject to the stamp tax).

XI. Caveat for New Hampshire Real Estate and LLCs

New Hampshire, unlike Massachusetts, imposes a transfer tax on the transfer of real estate to an LLC equal to 1.5% of the value of the real estate. For the unwary, this could be a very substantial problem. Consider the case of a shopping center worth \$10,000,000 which was owned by individuals who now wish to transfer it to an LLC. The cost would be \$150,000.

XII. Like-Kind Exchanges and Single Member LLCs

Single member LLCs are used in connection with like-kind exchanges, particularly where there is a so-called reverse exchange. A reverse exchange is a transaction in which the replacement property is acquired prior to the sale of the so-called relinquished property. This often is the case in connection with manufacturing companies that simply cannot shut down the plant and so they acquire the replacement property before selling their existing manufacturing facility.

In order to comply with the like-kind exchange rules, this property will be acquired by an intermediary. If, for example, First American Exchange would be utilized, First American Exchange would form a single member LLC and acquire the so-called replacement property typically with funds borrowed from the property owner.

Once the build-out is undertaken or at least until the existing property can be sold, the replacement property is owed by the exchanger. At such time as the manufacturing facility is sold, the proceeds will be transmitted to the exchanger and the seller of the plant will purchase the single member LLC interest from the exchanger.

In general, membership interests and stock interests are not eligible for like-kind exchange but a single member LLC, being a disregarded entity, is in fact considered property and therefore the acquisition of the single member LLC membership interest by the seller would qualify for like-kind exchange treatment. PLR 200118023.

XIII. Single Member LLC and Asset Protection

One important asset protection benefit to an LLC is the statutorily limited remedy of a creditor to a so-called charging order. See G.L. c. 156C, § 40. Generally, this means that unlike an interest in another type of entity, the interest cannot be taken to satisfy a judgment creditor. This benefit, however, does not exist in the case of a single member LLC.

In the case of *In re Albright*, 291 B.R. 538, (Bankr. Colo. 2003), the Court ruled that the assets of a single member LLC could be used to satisfy the creditors of Ashley Albright. The court denied that the charging order remedy is designed to protect the debtor's partners and not the debtor in the case of a single member LLC, since such there are no such members to protect.