Limited Liability Estate Planning or Tenants by Entirety – Which is Better?

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From time to time, I get asked about protecting assets as they move from generation to generation and how to assure certain assets remain within a family's blood line. Under normal circumstances when an asset, whether cash or real property, transfers to a child or surviving spouse, it is subject to that individual's discretion when it comes to distribution. This outcome may not be what the parent or deceased spouse had in mind when planning their estate transfer at death. There is a solution, but it might not be perfect in regards to the overall controlling goals of the benefactor.

One of the solutions is to consider placing the estate assets into a Limited Liability Company (LLC). Creating an LLC is as simple as going online to the Department of Corporations and filing as an LLC. In this case, consider doing this as a Joint Limited Liability Company with both spouses named as managers. However, if you are a single individual, the same outcome can be accomplished.

As managers, each spouse will have decision and controlling capacity as to the management of the assets. You'll be able to create an operating agreement which is the critical piece of controlling the asset into the future. Within the operating agreement you can limit the transferability of a particular asset. You can also limit the means of who can become a member (or manager) to the LLC. Why is this important? If your goal is to keep a particular piece of property in the blood line and prevent such property from arbitrarily being sold or partitioned, the operating agreement can prevent such actions.

For example, at the death of one of the spouses, the goal might be to limit the sale of the family property (e.g. beach or farm). The operating agreement should state that certain property continue to be managed and is prevented from being sold without the consent of all managers (remember that you can limit the inclusion of members and managers). Thus, control of property can be maintained.

An additional bonus is the limitation to judgments. Judgments are limited to charging orders against one of the members or managers interest in the joint LLC and not the assets themselves. With regard to resolving disputes within the LLC, such disputes can easily be resolved in the operating agreement when it comes to managing the assets.

At the death of the one of the spouses, the share of the deceased member's LLC can be transferred to his or her trust instrument and continue to be managed by a successor trustee of his or her choice in accordance with the terms of the LLC's operating agreement. Unfortunately, one of the downsides of using an LLC as an estate planning technique is the possibility of losing the step-up in basis for tax planning purposes. This problem is very real due to valuation discounts the IRS my impose following the first spouse's death.

Compare this technique to assets that are titled in joint spouses names, better known as Tenants-by-the-Entireties (TBE). Assets which are TBE are protected against judgments that are charged against one of the spouses. However, protection against judgments is not effective when a judgment is against both spouses.

At the death of the first spouse, the property transfers to the surviving spouse by operation of law. When this occurs, the property is subject to the discretion of the surviving spouse in terms of what happens to it going into the future. Thus, in a mixed children marriage, the surviving spouse could arrange for the property to transfer to her children exclusively. This possibility may not be what the deceased spouse had in mind prior to death.

From a taxing standpoint, at the death of the first spouse, the value of the asset will step up in basis and at the death of the surviving spouse, that spouse's interest in the property will also step-up to the current fair market value at the time of death or 6 months thereafter. This virtually eliminates any capital gain in the taxing of the property being transferred to the surviving spouse's children should the property be sold shortly after being conveyed.

There is no real control over disputes in managing the property in a TBE. Each spouse could exercise a unilateral change to the asset by changing its status from TBE to Joint Tenants in Common. Doing so would give such spouse the right to partition the property or insure his or her interest transfers to their blood line at death.

From a control aspect, the transfer of your property to an LLC is clearly superior to property held in a TBE. However, the downside to an LLC is the loss of a clear ability to get a step-up in basis to the property as it passes from one person to another. What matters to your selection of transfer will depend on whether you want long term control or ease of transferability with taxation benefits. If you are not sure what would be best for you, visit the attorney of your choice and discuss what you want to achieve following your death.

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