USING LIMITED LIABILITY COMPANIES
FOR REAL ESTATE INVESTMENTS

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Real estate investors are choosing to form Limited Liability Companies ("LLC") over any other entity because of the many potential legal and tax benefits it provides. With the simple and cost-effective approach for ownership, the LLC has become a favorite for not only those larger real estate ventures, but also for those smaller investments where a few friends or family members come together to purchase rental property in hopes of building their real estate empire.

As discussed in further detail below, when considering which entity to organize for the purpose of holding real estate investments, the LLC should be the entity of choice when compared to an S or C corporation, a general or limited partnership, or a real estate investment trust. As also discussed below, an LLC's tax benefits favor setting up an LLC for holding real estate investments.

What is an LLC?

It is important to initially discuss what an LLC is before discussing the advantages of setting up an LLC. An LLC is a hybrid between a corporation and a partnership. Like a corporation an LLC is a legal person that is created under state law. It has certain legal rights and obligations such as the right to transact business and the obligation to pay taxes. One common thread behind both the LLC and the corporation is that it allows real estate investors to invest money for their new real estate ventures but not risk unlimited personal liability. In other words, the Members, or owners, of an LLC, like shareholders of a corporation, are generally not responsible for the debts and obligations of the LLC beyond their contributions to the LLC.

An LLC, if properly structured, is not taxed at the entity level like a corporation. Rather, it is taxed like a partnership where an LLC's profits are taxed on its Members' individual tax returns. Accordingly, there will only be one level of taxation, not two layers of taxation that occur with a C corporation.

When considering which entity to choose from, real estate investors must know which options are available to them and how they compare to other viable options, such as an LLC, an S or C corporation, a general or limited partnership, or a real estate investment trust, discussed as follows:

LLCs v. C and S Corporations

Many of an LLC's benefits are available without the various restrictions faced by both C and S corporations. LLCs address many practical issues faced by closely held small businesses. All these businesses wish to have limited liability for their owners. In order to accomplish this objective in the past, they have had to organize either as a C corporation and face double taxation, or as an S corporation and face severe restrictions on the structure of equity interests and shareholder numbers and characteristics.

In addition, setting up an S corporation as the ownership vehicle for real estate is rarely appropriate. This is because the entity level debt of an S corporation cannot be included in the tax basis of its shareholders even if the debt is personally guaranteed by the shareholders; and special allocations, common to many real estate ventures, cannot be structured within the scope of the S corporation's one-class-of-stock requirement. Moreover, at the state tax level, many states impose a corporate tax on the income of an S Corporation, which makes this form of entity less attractive to utilize.

LLCs v. General and Limited Partnerships

The general partnership form historically has been unattractive to real estate investors because partners lack limited liability protection. Limited partnerships, perhaps the most commonly used business form in real estate transactions, are often unsuitable because they preclude limited partners from actively participating in the management of the business or risk losing their limited liability protection. In addition, at least one partner must be liable for the business debts in a limited partnership.

The benefit of an LLC is that all its Members are able to manage and control the business without causing the LLC to be taxed as a corporation. Members of an LLC can directly participate in the company's management or can elect Managers to manage the business. This is a key distinction between an LLC and a limited partnership, where limited partners risk losing its limited liability if they actively manage the business.

When comparing the use of a limited partnership with a limited liability company, both entities can limit the liability of its owners. In a limited partnership, however, the general partner will still have unlimited liability. This problem can be alleviated by setting up a corporation as a general partner. Now the corporation is the partner that is liable. Since corporations have limited liability, no individual owner is liable. This structure, however, results in further complications such as more start-up costs and the filing of more annual tax returns. The advantages of setting up an LLC is that it avoids the need for two entities (the corporation as a general partner and the limited partnership), is less costly to set up, and requires fewer annual tax returns and other complications.

<u>LLCs v. Real Estate Invests Trusts</u>

A real estate investment trust ("REIT") is a trust or corporation organized to hold real estate assets. It is generally owned by a large number of shareholders. Although a REIT may be classified as a corporation, it can qualify to avoid tax on most of its income, that is, if it meets the many strict REIT tax requirements. Once these complex requirements are met, the taxes can then pass through to its shareholders. The LLC may offer a possible alternative to the use of a REIT for real estate investing. Most importantly for real estate investors, this can all be accomplished with far less complexity and administrative costs that are associated with REITs.

<u>Tax Considerations</u>

Although tax reasons should not be the sole reason for setting up a specific entity, they do play an important role in the decision making process. Along with the single-level of taxation, an LLC provides an opportunity for real estate investors to: (i) characterize income and losses derived from the entity as potentially active income losses; (ii) have the flexibility to allocate its tax benefits on special allocations of income, gain, and loss from an investment; and (iii) have recourse liabilities allocated to the its Members, just to name a few of the tax benefits. A tax advisor should be consulted to discuss these complex tax benefits in greater detail.

In sum, the real estate investors will definitely benefit from the simplicity, costs, legal and tax benefits that are associated with setting up an LLC to hold their real estate investment properties as compared to the other legal entities available to them. For those few friends or family members beginning to build their real estate empire, setting up an LLC is the first step in accomplishing this task.

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