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Asset Protection: LLCs for Commercial Real Estate

Introduction

While keeping your assets "offshore" may seem exotic and appealing, it is greatly inconvenient, not without risk, expensive, and not really necessary in most situations. There are a variety of forms of operating a business, each having advantages and disadvantages. I have prepared a chart overview of these factors for your reference. (See sidebar.)

Many individuals and families who have or are acquiring rental real estate are taking advantage of the limited liability features afforded by the Corporations Code by owning and operating their rental under a limited liability company ("LLC") format.

These entities are attractive because they offer limited personal liability, like a regular C corporation, they are relatively easy to form and operate, and they afford pass-through taxation that avoids the double taxation imposed on C corporations. On the other hand, there are startup costs, State registration and reporting requirements, and an extra set of income tax returns to prepare each year (unless you have a one member LLC).

Here is a review of the benefits of an LLC as the owner of your rental real estate . . . .

Limited Liability

Relying on the insulation from personal liability by virtue of the form of the entity owning your rental itself is, in my opinion, not very unwise. It is more prudent and effective to combine the protections of your LLC entity with liability insurance to cut down the risk that your personal assets will be exposed to liability in a "worst case" situation.

Liability insurance in itself is a less expensive alternative to using an LLC. It avoids the formation and annual maintenance and costs required of an LLC; at least as far as the policy limits exceed your estimate of your risk exposure. If you feel that the cost and trouble of owning your rental in an LLC is not worth the protection you receive, or that liability insurance adequately covers your estimated risks in operating your rental, then you may find the insurance to be sufficient.

However, are you certain that your policy doesn't have any limits or exceptions that create uncovered exposure even though your policy limits seem to be adequate? What is your assessment of the risk of relying solely on your insurance for liability protection?

Individual ownership of your rental exposes you to being named in a lawsuit by an injured tenant, a guest of a tenant, or even a trespasser. To the extent your insurance itself or the policy limits do not cover the judgment awarded to the injured person, your personal assets are available for collection of any unsatisfied judgment.

By restricting liability arising out of the assets or their use by the owning entity, ones personal assets acquired virtual immunity from lawsuits. Traditionally, this type of protection was only available by using a regular C corporation to own the rental and take the income from the corporation in terms of salaries and dividends. That traditional liability protection is no available to limited liability entities formed under state law.

If your rental is owned by an LLC, only the LLC's assets are exposed to lawsuits. Your personal assets cannot be touched in most situations. That is analogous to owning stock in a regular C corporation where the entity's creditors cannot reach your personal wealth unless the corporation was improperly formed and/or operated.

I think that an increasing number of rental owners are recognizing the increasing likelihood of being sued and find the protection afforded by the LLC well worth the cost and extra work. Also consider that, if you participate in the management of the LLC, you are personally a target for the lawsuit where, in the end, liability is not attached to the entity for something you did or omitted to do that caused harm to another. So we return to the matter of acquiring sufficient liability insurance to cover this type of exposure.

Tax Benefits -- Pass-Through vs. Double Taxation

Another advantage of an LLC is the owners' ability to enjoy the benefits of pass-through taxation. A C corporation is subject to double taxation: once at the corporate level and again when dividends are paid to shareholders. For a long time, holding assets in a regular corporation was the "cost" of obtaining limited personal liability. Then the owners of corporations became able to be taxed as pass-through entities (single taxation) by electing subchapter S status. However, "sub S" corporations had limited benefits when holding investment assets like real estate due to the many restrictions and requirements necessary to obtain and maintain their tax status.

Things changed in 1988 when the IRS issued a ruling that an LLC formed under state law would be taxed as a partnership without losing the limited liability afforded its owners under state law. This is attractive because LLC has far less formality and cost of operation than either form of corporation.

Under the default tax classification rules, the IRS classifies a real estate holding company with one owner as they would a sole proprietorship, namely as a "disregarded entity." As a result, income and capital gains from the LLC pass through directly to the owner, who would only have to pay taxes as an individual, while still enjoying the protections offered by the LLC liability shield. The owner can avoid double taxation on the rental income and taxation of property appreciation (capital gain) at the time of sale. Also, the owner can continue to deduct mortgage interest as a sole proprietor.

Real estate holding companies having several owners are known as "multimember" LLCs and are generally taxed by the IRS like partnerships, meaning that the LLC files an "informational" tax return, but does not actually pay taxes itself.

Pass-through taxation allows the single and multimember LLC to pass its profits and losses to its members without out taxation at the entity level. The member then reports the income and deductions passed through on a Schedule C (single owner) or Form 1065 Schedule K1.

Operational Benefits

LLCs offer numerous other general benefits relative to other entity forms that aren't necessarily unique to—but certainly apply to—the use of LLCs to hold real estate investments.

> When delegating the responsibilities of management, LLCs have greater flexibility than either a corporation or partnership. While corporations are statutorily required to have officers and directors, the LLC can be easily managed by its owners or third-party managers.
>
> In the many states that impose increased fees based on the authorized number of shares, LLCs may pay lower state registration and maintenance fees than corporations.
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> Owners of LLCs can take advantage of the tremendous flexibility in the distribution of profits, as determined by the LLC's Operating Agreement. Cash flow distributions do not have to be pro rata according to ownership like an S corporation, which gives the owners the ability to financially reward the "sweat equity" effort of select members through appropriate distributions of available cash flow.
>
> Unlike an S corporation, foreign ownership and investment in U.S. real estate is possible through an LLC.

LLC owners can also easily transfer their ownership in real estate holdings by proactively gifting the company's membership interests to their heirs each year. Over time, it is entirely possible to effectively pass ownership of real estate owned by an LLC to loved ones without ever having to formally execute and record a new deed. This enables property owners to avoid transfer and recording taxes and fees, which can be substantial in many states.

Caveats and Cautions

Should you put a rental in an LLC? Probably. The benefits outlined above certainly seem to be the least costly means of achieving limited liability protection. However, as mentioned, we live in a litigious society, and the likelihood of a lawsuit originating from the condition and/or operation of your rental real estate becomes greater and greater.

I believe the most responsible answer to this question is: First, obtain a respectable umbrella policy for your entity and for yourself personally. Utilize the LLC form of ownership to acquire the state law "limited liability" protections. And anticipate liability-creating situations by keeping your property well maintained and in a safe and healthful working order.

Another caution relates to your purchase loan and any junior liens recorded against your rental property. Check your loan agreements and check with your lenders to make sure your transfer of ownership to your LLC will not result in calling your loans, thereby unnecessarily creating financial havoc. While on the subject, also investigate whether your lender is willing to provide your LLC with a non-recourse loan so that you avoid personal responsibility if the loan goes into default. It is my understanding that most banks still will not lend to an LLC, only to the individual owner(s). Be clear on whether the loan will be called if your LLC sells the property. Finally, ask your tax advisor about the personal tax consequences of transferring your rental to the LLC. You don't want to overlook any capital gain liability in the process of forming your LLC.

A further level of protection would be to use a well-prepared rental agreement that includes liability and hold harmless provisions in your favor.

Finally, consider diversification by owning multiple properties in separate LLCs so that any liability arising in relation to any one property does not expose the other properties owned by the LLC to the judgment collection.

Now that you know the benefits and drawbacks of using LLCs, consider your own situation and whether cost-benefit equation in your particular case dictates how you should proceed. For example, are you getting a greater tax savings than the annual cost of operating the LLC? Be particularly careful about the costs involved; especially whether transfer of your property to the LLC will affect your mortgage, your property taxes, etc.

While a bit lengthy, this summary of using LLCs to own rental real estate is by no means comprehensive. My intent here is to impart information that you may use to focus your own questions and concerns. That may be useful in itself or as a means of equipping yourself for our consultation.