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LLC

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PERIODIC NEWSLETTER AND LEGAL UPDATE

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SUMMARY

BUSINESS LAW:

An Overview of Using LLCs to Hold Real Estate

Over the last decade, limited liability companies (LLCs) have become one of the most preferred forms of business entities through which to hold title to investment real estate properties. The insulation from personal risk exposure for real estate investors provided by LLCs, coupled with the relative ease of administration and potential tax benefits, make ownership of investment property through an LLC a very desirable option in most instances.

LLC vs. Liability Insurance

Although there are many benefits to holding real property assets in an LLC, an LLC may not be the best holding vehicle for every property owner. For many real estate investors, the trouble of forming and maintaining a company isn't worth protection from the potential risk of a lawsuit, particularly when affordable liability insurance is available. With that said, however, real estate investors that rely solely on insurance as a means of protection from personal liability take a significant risk. Liability policies typically have limits, exceptions, and carve-outs, and while the chance of a loss exceeding the policy limits may be remote, if it does happen and the consequences can be devastating. Under current laws and market trends, the popularity of real estate holding LLCs is very likely to continue to increase as more and more property owners seek to take advantage of the benefits offered by this form of entity in South Carolina.

LLCs Limit Personal Liability (Inside Liability)

First and foremost, LLCs limit personal vulnerability to potential lawsuits related to the property. Consider the situation in which the owner of an investment property leases it to a tenant who decides to throw a big party, during which one of the tenant's guests falls over a balcony. In today's legal climate, it is quite possible that the injured guest (or the family of a deceased guest) would pursue a claim based on the “unsafe condition” of the rental dwelling. More often than not, the owner would be named in any lawsuit resulting from the incident. If that rental property were owned by a real estate investor individually, he or she would be named in the lawsuit and would have to defend his or her personal assets from the plaintiff's claims. In contrast, if that property were owned by an LLC whose sole asset was that rental property, the owner's other assets and overall risk exposure would be insulated by the protection of the LLC, leaving only the assets owned by the LLC (as opposed to all of the owner's personal assets) exposed to such judgment creditor claims.

LLCs Protect Assets from Other Liability (Outside Liability)

In addition to inside liability, holding real property in an LLC also insulates those assets from judgments arising from claims unrelated to the property. Once again, consider a different situation where the real estate investor was determined to be liable for a terrible automobile accident in which another was injured or killed. A torts litigator will look to all assets of the investor in efforts to satisfy the plaintiff's claims. If that rental property were owned by the real estate investor individually, the property could be forcefully liquidated by a court and lost. In contrast, if the investor's real property were owned by an LLC or in multiple LLCs, and assuming a qualified attorney incorporated the necessary language into the operating agreements for those LLCs, a judgment creditor could not force the liquidate of the investor's properties but instead, would only be entitled to a charging order whereby any disbursements from the LLC that would have otherwise have gone to the investor, would now go to the judgment creditor. This insulation renders the real property held by LLCs far less attractive as a source of funds to satisfy the plaintiff's claims. Thus, the assets owned by the LLC (as opposed to the owner's other personal assets) enjoy enhanced protection from such judgment creditor claims.

Pass-Through Taxation for Single & Multimember LLCs

Another advantage of an LLC is the owners' ability to enjoy the benefits of pass-through taxation. For over 25 years, the IRS has recognized that LLCs would be taxed as partnerships even though they provide for corporate-like protection against liability. C corporations, in contrast, are subject to double taxation—once at the corporate level and again when dividends are distributed to shareholders. While the owners of corporations can achieve pass-through taxation by making an "S" election, S corporations are subject to many other restrictions and requirements that limit their utility in the real estate investment realm. 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.

Since there is no separate LLC tax, the owner can avoid double taxation on both the rental income generated by the property and the appreciation in value of the property upon disposition. Moreover, the owner of a single-member LLC can deduct mortgage interest similar to a sole proprietor based on current IRS rules.

Real estate holding companies that have 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.

Multimember LLCs also enjoy the benefits of pass-through taxation as the LLC passes its profits and losses through to its members, who report their portion of the LLC's business income or losses on either a Schedule C, K or Form 1065 with their individual income tax returns. This means that both single member and multimember LLCs offer the benefits of pass-through taxation of profits and losses and limited liability and personal protection for the owners.

LLCs Are Not All Roses

Despite the numerous advantages of LLCs for protecting real estate investments, it's appropriate to touch on some of their shortcomings as well.

- Properly structuring an LLC cost money both in filing fees to the Secretary of State as well as the attorney fee for drafting the LLC operating agreement and obtaining a taxpayer identification number for the entity.

- When you are creating an LLC, you are essentially creating a separate account that you have to manage—and if you have a bookkeeper, you may have to pay him or her more for having to work with an additional account/paperwork. Likewise, an investor's accountant may charge more to file an informational return if an LLC has more than one member.

- Generally, each LLC must have a separate bank account. Multiple accounts may be advantageous to track income and expenses for each property, but many clients find the monthly statements and checkbooks overwhelming. Our firm, however, is able to structure your LLCs to avoid the need for multiple accounts and encourage you to contact us if interested.

- As briefly mentioned earlier, it's occasionally harder to qualify for certain loans when using an LLC. Again, please contact us to discussion available options.

- In most situations, it's also harder to qualify for certain loans when using an LLC, and in some states evictions must go through a lawyer.

LLCs have many legal and tax advantages, but it is important that you consult with your qualified legal team to make sure that, not only is an LLC a good fit for you, but also for the type of real estate investments you have. Again, we are available for questions at any time!

Minimize Risks with the Right Strategy

There is simply no way to eliminate all the risks associated with starting a real estate investment business, but you can easily enhance the protection of your assets by complying with the corporate formalities required by applicable laws, even though these steps may seem tedious and somewhat confusing.

If you are in the market for investment real estate, you should at least consider whether or not the acquisition through an LLC is the right choice for you. If so, it is much easier to purchase the property through the LLC to begin with, as opposed to trying to transfer the real estate to an entity at a later date where a lender might have to consent to the transaction. That said, if a lender seems to have a problem with title held by an LLC, please call us to discuss your options. We are available to answer your questions at any time.

This Newsletter is based on current law at the time written and is for informational purposes only. It is important that you discuss all legal options and consequences with a

qualified attorney prior to any action. Should you wish to discuss any questions with us, please call (843) 795-1909 to schedule a consultation. For additional Newsletters, please call us or visit our website at www.Bradshaw-Company.com.

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