

Understanding the Limited Liability Company **by David C. Burgess, Esq.**

One of the most important decisions for a real estate investor is choosing a form of entity. An attractive option selected by thousands since its introduction to California in 1994 is the limited liability company (LLC).

The main alternatives to an LLC are a C corporation, an S corporation, a general partnership, or a limited partnership. Each of these forms has pros and cons.

In an LLC, like a corporation, the owners, officers, and managers are not personally liable for any debts or liabilities of the business.

In deciding which entity is best, real estate investors should assess such factors as liability protection, tax treatment, management flexibility, and ease of formation. An LLC generally equals or beats the competition in all of these areas. Let's take a closer look.

Liability Protection

Liability exposure is a primary concern for any real estate investor. In an LLC, like a corporation, the owners, officers, and managers are not personally liable for any debts or liabilities of the business. This feature is increasingly important to real estate developers and investors in light of the expanding scope and magnitude of environmental and other liabilities.

Unlike a corporation, the failure of the LLC to hold meetings or to observe formalities does not jeopardize this protection from personal liability. Thus, an LLC can be run more loosely than a corporation.

A general partnership does not offer limited liability. Rather, all partners are personally liable for liabilities of the partnership.

A limited partnership shields the limited partners from liability, but only so long as they are not actively involved in the business. In contrast, owners of an LLC may actively participate in the business without forfeiting their limited liability. In addition, a limited partnership must have at least one general partner, who will be personally subject to partnership liabilities.

Tax Treatment

For various tax reasons, real estate ventures traditionally have been operated in partnership form. An LLC can elect partnership tax treatment, with tax items flowing through to the owners. An LLC thus will offer the following tax benefits:

- Owners of the LLC generally may deduct losses of the business on their personal returns, subject to the "passive loss" and "at-risk" limitations.
- There is no double taxation of income of the LLC that is distributed to the owners.
- An LLC owner's tax basis is increased by his share of LLC liabilities.
- An LLC may have special allocations of profit and loss among its owners.
- A party normally will not be taxed on the receipt of a profits (as opposed to capital) interest in the LLC issued in return for services rendered.

A C corporation does not provide these tax benefits. Even an S corporation supplies only some of these benefits, despite being a pass-through entity. Moreover, an S corporation is subject to various restrictions that limit its flexibility. Thus, an LLC generally is equal or superior to an S corporation for tax purposes.

Like a corporation or a limited partnership, an LLC must pay a minimum annual tax of \$800 to the State of California. General partnerships are not subject to this minimum annual tax.

Management

A variety of management structures are available to an LLC. An LLC may choose:

- A decentralized model with all owners actively participating in management, similar to a general partnership.
- A centralized model, with most management authority vested in one or more managers, somewhat like a limited partnership.
- A hierarchical model, with officers who are overseen by managers or the members, analogous to a corporation.

Thus, the owners have the freedom to select an arrangement that best fits their needs. Regardless of the management structure chosen, an LLC may (but is not required to) elect officers, such as a president, secretary, and chief financial officer.

Formation

The amount of work and expense required for formation of an LLC is similar to that for a partnership, and perhaps a bit less than that for a corporation.

A limited liability company is formed by the filing of Articles of Organization with the Secretary of State on a simple one-page form. The name of the LLC must end with either the words "limited liability company" or the abbreviation "LLC".

The members of the LLC also must enter into an operating agreement delineating their business relationship. The operating agreement is similar to a partnership agreement.

Beneficial Uses of LLCs

New Projects. Any new real estate venture should seriously consider operation as an LLC. The LLC provides limited liability, advantageous tax treatment, and maximum management flexibility.

Existing Projects. An existing partnership may be converted into an LLC, typically by merging into an LLC. The conversion generally will be free of income tax, property tax reassessment, or transfer tax. In contrast, conversion of a corporation into an LLC usually will trigger income tax.

Joint Ventures. An LLC is an excellent vehicle for joint ventures. It provides the desired limited liability and partnership tax treatment without the need for establishing more complex and expensive joint venture structures.

Estate Planning. An LLC can be employed as an estate planning instrument for the transfer of assets that are difficult to value or divide, such as real estate or a closely held business. This use of an LLC (like a family limited partnership) has the benefit of allowing the transferor to remain in control of the transferred assets.

Conclusion

Although an LLC may be profitably used in a variety of contexts, it is particularly well suited for holding real estate. Indeed, on the merits, the LLC would seem the entity of choice for real estate ventures.

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