

The Best Entity to Hold Real Estate

Contributed by Garrett Sutton, Esq
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Possibly THE most frequently asked question of me is "What is the best business entity to use for real-estate investments?" My recommendation to most people is that a limited liability company (an "LLC") is the best entity for this type of use.

Here's why:

- Excellent liability protection for managers and members
- Flow-through tax treatment on LLC profits and losses
- Ability to transfer properties in and out of an LLC with minimal tax consequences
- Personal Asset Protection through the Charging Order procedure (for Nevada LLCs)

Liability Protection.

An LLC is similar to a C-corporation ("C-corp") or a Sub-Chapter S corporation ("S-corp") in that it exists as a separate corporate entity. It provides full liability protection to its officers and directors (called "Managers") and its shareholders (called "Members"). As either a Manager or a Member, you are liable only for the money you have invested into the LLC and cannot be found personally liable for any debts incurred by the LLC. Consider the risks associated with owning real estate, especially rental properties. Tenant injuries. Trespassers injured while on vacant land. Unauthorized dumping or storing of hazardous waste. All of these could pose a serious risk to your financial well-being if you held the property in your name directly, even with insurance. Owning property in your own name means that in the event you are sued and found guilty, anything your insurance policy does not cover will come out of your own pocket. Putting an LLC entity between you and this personal liability means that your personal assets will stay protected.

Flow-Through Tax Treatment.

Unlike a C-corp, an LLC does not pay income taxes. It is a "flow-through" entity, meaning that, like an S-corp, the tax on the profits (as well as the write-offs on any losses) are passed through to the Members and taxed on their individual personal tax returns.

The flow-through tax treatment becomes important when you decide to sell a property, or convert it to personal use. Here's a quick example of what happens to a \$400,000 profit on real estate after taxes. For this example we are assuming that your personal tax rate on the monies received would be 39.1%, the top tax bracket:

C CORPORATION:

Gross Profit: \$400,000
Less: Corporate Tax: -136,000
Subtotal: \$264,000

Paid to You as a Dividend: \$264,000
Less: Tax You Pay on Dividend: -103,224
Net Profit to You: \$160,775

LLC

Gross Profit: \$400,000

Paid to You: \$400,000
Less: Tax You Pay on Profit: -156,400
Net Profit to You: \$243,600

Ease of Sale.

LLC's have an extra advantage over an S-corp (or a C-corp) where you want to convert a property to personal use, or trade it (called a "like-kind exchange" and subject to special rules) for another home of similar value. If held in an S-corp the conversion or trade of property would be considered a sale with the accompanying tax consequences. Held in an LLC, there are no tax consequences to converting or trading the property.

Asset Protection.

When using an LLC to hold real estate, it is very important that you also obtain comprehensive property insurance coverage. In the event of a lawsuit brought against the LLC by a tenant injured on the premises, or, believe it or not, even by a trespasser on your land, good and comprehensive insurance can save you money in the long run. It may even save the property itself if a claimant was to successfully sue the LLC and win. If the LLC had no insurance coverage in place a court may order the property sold to pay the claimant's judgment. However, if a lawsuit is brought against you personally, and a claimant attempts to seize assets you hold through an LLC, the rules are a little different.

Charging Orders.

A charging order works in the same fashion as a lien -- it is an obligation to pay money placed over assets. The charging order does not convey any voting rights, any ability to control the decisions of the LLC or the ability for a creditor to force the LLC to make profit distributions. The charging order merely grants the creditor the right to receive a portion of the LLC's profits until the judgment is completely paid. And, in a fairly ironic twist, the monies received by a judgment creditor through a charging order will be treated as income and taxed.

Under Nevada law, a charging order is the sole legal method for creditors suing you personally to attack your assets held in an LLC. So for example, if you are a Nevada resident and have a day trading account, a boat and a duplex held in an LLC and are sued personally, a creditor would not be able to seize your assets. They would instead have to obtain a charging order over your membership interests in the LLC, entitling them to receive a portion of income earned by that LLC. If the LLC didn't earn any income, then there would be no profits to be distributed.

Unfortunately, the charging order laws in other states may not be as strong as Nevada. For those of you who don't live in Nevada, or who hold property in another state that does not offer strong charging order laws, we suggest using two LLCs. The first LLC is formed in the state where your property is located and holds title. The second LLC is formed in Nevada and is a passive holding company, holding all of the interests of the first LLC. You in turn hold interests of the Nevada LLC. What will happen in the event of a lawsuit brought against you personally is that no matter in what state a lawsuit is brought, a creditor will eventually have to come to Nevada to attempt to seize the assets, and will then run up against the charging order procedure. It costs a little more to set up and maintain, but if you are truly trying to make yourself as small a target as possible, it is a fairly cost-effective solution.

One final point to consider while on the subject of charging orders is to limit the number or dollar value of properties held in an LLC. If you have several properties held in an LLC and you depend on the income stream, then a charging order placed against that LLC could cause a major disruption to your earnings.

Do I ever NOT recommend using an LLC for real-estate holdings? Occasionally. For example, California assesses an additional franchise tax fee for LLCs with earnings over \$250,000 per year. So, if your LLC is holding very high income-earning properties, you could wind up paying extra taxes. To avoid that, we may recommend that you use a Limited Partnership, as it does not have the extra franchise fee levied on its earnings. However, if you operate your Limited Partnership with a corporate General Partner, then you have the filing and operating costs for two entities in California, rather than one, not to mention two franchise tax fees.

Another example could be a situation where the entity is going to be used for estate planning purposes to pass your wealth through to the next generation, and you perhaps foresee trouble on the horizon with your children wanting control once they have gained a majority interest.

Limited Partnerships are a much older entity than LLCs, and the law over how the Limited Partnership is controlled is much more settled. A General Partner cannot be removed in most instances unless they are found guilty of serious misdoings or defrauding the Limited Partnership. In an LLC, however, the law isn't as settled. And, though you might draft your LLC's operating agreement as strongly as possible to give you control over daily operations, even after you have transferred majority interest in the LLC to your children, there is still a chance that the kids will be able to make a good legal argument in front of a sympathetic judge and have the operating agreement set aside.

Garrett Sutton, Esq. has advised countless individuals and business owners on asset protection strategies. For more information and a complete overview of the most effective uses of LLCs and Limited Partnerships, please visit <http://www.sutlaw.com>