The Unthinking LLC

Since they were originally created in 1977, Limited Liability Companies ("LLC") have gone from obscurity to almost the automatic choice for real estate ventures. LLCs are useful entities that generally offer the liability protection of a corporation with the flexibility and tax benefits of a partnership. As a result, many attorneys and accountants recommend using an LLC for a client's real estate business without much thought. In this article, I intend to introduce a consideration into the decision of whether property owners should use LLCs to hold their real estate.

Bob and his brother, Rob, just inherited 5 commercial buildings in San Francisco from their mother. Their attorney has recommended that they transfer their properties to a legal entity for liability protection and the lenders require that each property be held by a separate legal entity. Bob and Rob agree and would like to use entities that are taxed as partnerships for federal income tax purposes in order to minimize the tax impact of holding their properties in legal entities.

Prior to the introduction of LLCs, Bob and Rob's best choice was to use a limited partnership with a corporate general partner that owned 1% of the partnership. A limited partnership must have at least one general partner and general partners have unlimited liability for the partnership's debts. Thus, in order to fully protect Bob and Rob, they were required to form a corporation to act as the general partner of the limited partnership. An election would typically be made to treat the corporate general partner as a sub-chapter S corporation for the optimum tax results.[1] Bob and Rob would typically own both the limited partnership interests in the limited partnership and the stock of the corporate general partner. Bob and Rob would also have to comply with the rule that limited partners are restricted from participating in the management of the partnership. With this structure, Bob and Rob would achieve liability protection with the tax advantages of a partnership. Nonetheless, two legal entities (the limited partnership and the corporate general partner) are required to achieve full liability protection for the property. The same corporate general partner, however, can serve as the general partner for each of the five limited partnerships formed to each hold a separate building. Therefore, Bob and Rob’s 5 buildings would require the formation and maintenance of 6 entities (five limited partnerships and one corporation). Each entity requires annual corporate filings and tax returns. Nonetheless, prior to the creation of LLCs, this was standard practice in the real estate industry and functioned effectively.

The creation of LLCs offered taxpayers another option. LLCs are taxed like limited partnership, provide their owners with liability protection, but do not require a general partner. Additionally, the owners of the LLC are not restricted from managing the entity like limited partners are with a limited partnership. Consequently, they have quickly become the favored entity for real estate.

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[1] Unlike a regular, or "C corporation", an S corporation is generally not subject to income tax. Instead, like a partnership or LLC, the profits/losses of the S corporation flow out to the shareholders and are taxed at the shareholder level. This may prevent the double taxation of income which can occur with C corporations.

Bob and Rob could achieve their desired results but only have to form and maintain 5 entities.[2] Based on this conclusion, thousands of LLCs in California have been formed over the past few years replacing the traditional limited partnership with corporate general partner structure.

The Consideration – California Taxes

Generally, California does not apply an income tax to limited partnerships, LLCs and S corporations (instead it taxes the owners of these entities). It does, however, apply at least three other types of taxes to the entities. First, it imposes a $800 minimum annual franchise tax ("MFT") on LLCs and limited partnerships. Second, it applies a 1.5% tax on the net income of S corporations, which tax must be at least $800. Third, California imposes a tax on the gross receipts of LLCs at graduated rates. The tax on an LLC with $500,000 in gross receipts is $2,500.

Assume that each of Larry and Lance's 5 buildings generates $500,000 in annual gross rents and has $400,000 in expenses (net income of $100,000). Below is a comparison of the impact of the California taxes discussed in the prior paragraph if Larry and Lance used limited partnerships (with corporate general partners) or LLCs to hold their real estate.[3]

A. <u>Limited partnership and S corporation general partner (10 entities)</u>. Note: the S corporation owns 1% of the limited partnership, it is therefore allocated 1% of the partnership's net income (or $1,000).

MFT on Limited Partnership	1.5% Tax on S corp (minimum of $800)	Sub-Total (per building)	Total per year for all entities
$800	$800	$1,600	$8,000

B. <u>LLCs (5 entities)</u>

MFT on LLC	Gross Receipts Tax on LLC	Sub-Total (per building)	Total per year for all entities
$800	$2,500	$3,300	$16,500

Conclusion

As shown in the above chart, using LLCs will cost Larry and Lance $8,500 more per year in California taxes then using limited partnerships. The result of the above comparison will vary

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[2] There are a few additional benefits of LLCs over limited partnerships which may be important in some situations – for example, LLC owners can all legally managed the LLC while limited partners are not permitted to managed the limited partnership. In our example, however, Bob and Rob may manage their limited partnerships in their capacities as officers and directors of the corporate general partner.

[3] An alternative structure is to form a limited partnership to hold the commercial building and use an LLC as the 1% general partner instead of an S corporation. I discussed using an S corporation as the general partner in this analysis since most real estate professionals are familiar with this arrangement.

considerably depending on the number of properties involved and the rents/expenses of the properties. To further complicate this analysis, some of the above California taxes are deductible against federal and state income taxes thus reducing their impact. It also should not be ignored that there are costs (both in terms of money and time) associated with forming and maintaining the extra entities required when using limited partnerships. Many people would gladly pay a few thousand dollars more a year for the simplicity of using LLCs.

I have made many generalizations and unstated assumptions in this analysis and omitted many tax and legal issues one should consider. By no means am I recommending that property owners decline to use LLCs since Larry and Lance would pay less in California taxes if they used limited partnerships. My only goal is to demonstrate that real estate owners should consider all of the costs before deciding to use LLCs in California. Nothing in this article should be construed as legal advice or a legal opinion.

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