



Real Estate News

417 Barre Street • Montpelier, VT 05602
Toll Free: 800-585-3169 • Tel: 802-229-4001 • FAX: 802-229-2733

www.montpelierlaw.com

January 2007

LLC's for Real Estate

Why LLCs are the preferred entity for investment real estate?

Law Office James Palmisano
Winter 2007

The Limited Liability Company (LLC) has become the entity of choice for holding title to real estate. It provides important liability protection for its owners, pass-through tax treatment and flexible management.

Formation: An LLC is formed by filing Articles of Organization with the Vermont Secretary of State. The Secretary of State will issue a Certificate of Organization which marks the beginning of the LLC's existence. Every Vt LLC must also have an operating agreement, which is a private agreement between the owners stating how the LLC will be run.

The LLC must designate a registered agent to accept service of process if the LLC is ever sued. Each year the LLC must file an annual report with the Secretary of State within 2 1/2 months of the end of its fiscal year.

Membership Certificates. Owners of an LLC are called members. A member's ownership of an LLC is represented by *interests*. Membership certificates are issued evidencing the amount of each member's ownership interest in the LLC.

Management: A limited liability company may be managed by either its members or by one or more managers. A "member" is an owner of the limited liability company. If a limited liability company is managed by the members, then the owners are directly responsible for running the company.

A "manager" is a person elected by the members to manage the LLC. In this context, a manager is similar to a director of a corporation. A manager can be, but is not required to be, a member. If an LLC is managed by managers, then its members are not directly responsible for running the company.

Whether an LLC should be managed by members or managers depends on several factors, including: The number of owners; the type of business, where the owners are located, and how involved the members will be in the LLC operation.

Income Taxes: The IRS does not recognize an LLC as a classification for federal tax purposes. Instead owners of an LLC file either a corporation, partnership or sole proprietorship tax return. This gives LLC's pass-through taxation, allowing earnings of an LLC To be taxed only once.

For tax purposes, a single member LLC is a "disregarded entity" and does not require a separate tax return filing. It is taxed as a sole proprietorship for tax purposes. All of the income, deductions, gains and losses of the entity are reported on the Form 1040 of the owner. (Note: A single-member LLC owner may also file IRS Form 8832 and elect to be taxed as a corporation).

A Husband and Wife LLC are required to file a partnership income tax return as is any other LLC having two or more owners. (Note: A multi-member LLC may also elect to be treated as a corporation).

Generally if the LLC is not conducting an active business but rather is merely investing in rental real estate a member's share of net business income is not subject to self employment social security tax (The SE tax is roughly 15.3 % of first \$100,000.00).

Sole Proprietorships and LLC Tax Returns. If the only member of the LLC is an individual, the LLC income and expenses are usually reported on Form 1040, Schedule C or E. If the income is reported on Schedule C, then it is subject to self-employment taxes. If the income is reported on Schedule E, then it is not subject to self-employment taxes. Income from rental property is usually reported on Schedule E and is not subject to self employment taxes.

Partnerships and LLC Tax Returns. For federal tax purposes, limited liability companies with more than one member are usually treated as partnerships, and LLC members are treated as partners. They must file Form 1065, U.S. Partnership Return of Income, on an annual basis, to report income and deductions. Each partner must receive a copy of Schedule K-1, Partner's Share of Income, Credits, Deductions, etc. The partnership return is an information return used to report the income, deductions, gains, losses, etc., from the partnership business. **The partnership does not pay income taxes.** It merely reports how much income the partnership had and how it was distributed among the partners. Each partner then includes his or her share of the partnership's income or loss on his or her tax return. If a multiple-member LLC doesn't engage in an active trade or business, however, then the LLC owners don't pay self-employment tax on their shares of the profit. And in this case, the LLC owners report their shares of the partnership's profit on their respective Schedule Es.

Capital Gains. In any transfer of property, you need to consult with your tax advisor. If you sell a rental property for more than it cost,

you may have a capital gain. Generally property transferred to a limited liability company in exchange for a controlling ownership interest is considered a capital contribution and does not recognize either gain or loss on the exchange. The transferee LLC takes a carryover tax/depreciation basis in the property received. The transferor's basis in the membership interest is the same as the basis for the property transferred.

Liability Protection: Most real estate LLC's are formed to shield a person's personal assets from claims relating to their rental properties. That is, in order to reduce or eliminate the risk that the person will lose other assets because of a problem with one of his or her properties. There are many potential sources of legal liability for the owner. From common slip and falls, to fire or carbon monoxide poisoning, landlords and owners are exposed to legal judgments. Landlords have been successfully sued by victims of crimes--such as robberies, rape, and even homicide--that occur on their property on the theory that the landlord provided inadequate security.

Accordingly, the LLC should hold title to your real estate so that if a lawsuit occurs, the LLC will be the defendant rather than you. This is the key to real estate asset protection. If you own the real estate, all of your assets are at risk. You must transfer title to the real estate to your LLC to reduce the risk you will be named as a defendant in litigation arising from the real estate. Note: Make sure to add your LLC as an "additional insured" to your hazard/homeowner's insurance policy.

You should also get a separate bank account for the LLC. The LLC isn't an extension of you, it's a legal entity itself. You need to keep a clearly distinguishable line between your finances and actions and those of the LLC. It's the only way that you will maintain the liability protection. You will need to follow essentially all the same basic procedures in terms of books and meetings as a corporation. Without these, the LLC can be declared null and everything falls back on to you.

The goal of protecting personal assets from

business risks is furthered by obtaining a separate EIN for the LLC so that it could open a bank account in the LLC's name, under its own tax ID number, rather than under the owner's SSN.

Many people who own multiple properties are able to further protect their assets by forming a separate LLC to own and hold each separate property. If the separate LLCs are properly formed and maintained, then theoretically only the assets owned by a specific LLC would be subject to claims or lawsuits against that LLC.

Loss of Liability Protection: Be advised that even if you form an LLC and transfer the real property to the LLC, you will remain liable for your conduct. For example, if your LLC owns a rental property, you install a new water heater, the water heater blows up and a tenant is injured, you will be sued because you are the person who caused the harm by improperly installing the water heater. Thus, after forming your LLC you have less risk of being sued if you hire a contractor to do certain jobs rather than doing them yourself.

You will also be liable for LLC debts you personally guaranteed. For example, some lenders may require your personal guarantee in order to loan funds to your LLC. If so, you will be personally liable if the LLC defaults and the value of the property is insufficient to fully satisfy the debt.

Other LLC Issues: The rest of this article will discuss how transfers to an LLC can affect *Vermont Property Transfer Taxes, Drop-Down LLC's, Loss of Title Insurance, and Mortgage Due on Sale Clauses.*

Vermont Property Transfer Taxes. As previously stated, the LLC should hold title to your real estate. In order to transfer property from your name to your LLC you will need to execute a new deed and record it in the town clerk's office. A Vermont Property Transfer Tax is imposed at the time the deed is filed with the town clerk for recording. At present, the general transfer tax rate is 1.25% of the sale price of the real estate being sold.

Fortunately, however, the law provides an exemption from the transfer tax for transfers to a corporation, partnership or LLC at the time of formation, if no gain or loss is recognized under the federal tax code. The Vt. Department of Taxes presently maintains an unwritten practice that to claim the exemption the transfer must be made within ninety (90) days from the issuance of an LLC's Certificate of Organization by the Secretary of State. See *Bookstore Properties, LLC v. Vermont Department of Taxes*, (2007) No. 10-24-07 Bncv.

Drop-Down LLC's. Some real estate investors save thousands in transfer taxes by use of the so-called Drop Down LLC. As stated above, Vermont imposes a transfer tax upon the conveyance of real estate by deed or other recorded instrument. The general rate is 1.25%. (The transfer tax on \$500,000.00 would be \$6,250.00). However, where the LLC owns a specific property a buyer could avoid paying the transfer tax by purchasing the ownership interests in the LLC. The LLC would still own the property, but the new buyer would own the LLC. This would be an unrecorded transaction and therefore would not trigger a transfer tax because no instrument of conveyance is ever recorded. This practice has been acknowledged by the Vermont Tax Department. See Tax Dept [Ruling 2004-01](#).

Proof of ownership of LLC consists of the LLC records, primarily the certificate of organization, the signed operating agreement, and the membership certificates. To transfer ownership you would execute either a bill of sale or a purchase and sale agreement. The new owner would then revise the operating agreement and change the registered office and agent of the LLC filed with the Secretary of State. New membership certificates would be issued.

Title Issues and Endorsements. If an individual who owns property has an owner's policy of title insurance, a lapse of coverage may subsequently occur if an LLC is later formed and the real property is transferred to the LLC. Care must be taken to avoid loss of

coverage under the owner's title insurance policy. The title company should be made aware of the transfer, and, if required, an "additional insured" endorsement should be requested from the title insurer.

Whether to transfer title to the LLC by Quitclaim Deed or Warranty Deed can also raise title insurance issues. Paragraph 2 of the Conditions and Stipulations of the standard ALTA owner's title insurance policy provides that coverage under the policy continues if the insured 1) retains an estate or interest in the land, 2) holds a purchase money mortgage from the purchaser, or 3) *retains continuing liability by reason of deed covenants of warranty*. When title is conveyed by quitclaim deed there is no such warranty of title. Therefore, if a title claim arises after the transfer, the grantor would not be obligated to defend the action and likewise the title insurance company would not be obligated to pay or defend the claim under the title policy. Thus, a conveyance to an LLC by warranty deed may allow the insured under the original title policy to retain coverage even after the transfer to the LLC. However, as stated above the issue is rendered moot by obtaining an "additional insured" endorsement.

Mortgage Due on Sale Clauses: Most people purchasing real estate will usually have to borrow funds in order to purchase the property. The bank or credit union loaning the funds will secure the loan by putting a mortgage on the property. Anytime you transfer the mortgaged property, there is a possibility of violating a "due on sale clause" included in most mortgages. This means the lender may request payment in full because the "due on sale clause" states when you sell the property you must pay the entire loan. Even a transfer to your LLC may trigger the due on sale clause.

However, this is usually more of a theoretical problem than an actual one. Here's why: If the lender were to "call the loan due" they would take a perfectly good, performing loan and turn it into a problem, non-performing loan on their books. Banks don't want this because it affects their financial statements and it does not look good to their investors. All the bank cares about is that the payments are being

made. Thus, if you make the payments you should not have a problem.

Thus, a transfer to an LLC should not present any more of a problem than a homeowner who adds a spouse or child's name to the title to his or her property. This happens all the time despite the fact that it could too be construed as a violation of the due on sale clause. The author of this article is not aware of even one instance where a Vermont lender has invoked the due on sale clause as a result of such a transfer.

Nonetheless, if you are concerned about the possibility of the loan being called due, simply send the lender a letter and let them know that you are transferring the property to an LLC for estate planning purposes and that, if they object, to let you know in writing within "x" number of days. Otherwise, you will proceed with the transfer. When they don't respond, you are okay. Save this letter.

Summary. Before LLCs gained popularity in the 90s, limited partnerships and partnerships were the entities of choice for real estate investment. Limited partners were protected from personal liability while also being able to take passed through tax losses from the property. The biggest downfall with limited partnerships was that someone had to be the general partner and expose themselves to unlimited personal liability.

LLCs don't require a general partner. LLC owners have limited liability protection and avoid the double taxation of corporations. For holding investment real estate, the LLC usually offers the best of all worlds when it comes to business entities.