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Real Estate Investments Held By Washington Limited Liability Companies (LLCs)

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I. What is a LLC?

A. It is a flexible business organization that provides the benefits of limited liability protection, a "pass-through" entity for income tax purposes, and an entity that can avoid certain corporate formalities.

B. A quick review of other business organizations helps put the LLC in context.

1. **Sole Proprietorship (individual or married couple).**
2. **General Partnership.**
3. **Limited Partnership or Limited Liability Partnership (LLP).**
4. **"C" and "S" Corporation.**

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C. History of LLCs in the U.S. and in Washington.

1. First used in Wyoming for oil, gas and mining operations in 1977, but has a longer history in Europe.

2. Washington enacted the Limited Liability Company Act in 1994. All states enacted LLC statutes and most vary by state.

3. LLCs were unpopular and not utilized until after 1997. Why?

a) Tax and legal uncertainties.

b) Generally not favored by capital markets.

II. Why A LLC May Be Suited For Real Estate Investments

A. Flexibility And Characteristics Of A LLC

1. The owners are called members; there may be one or more members. A LLC is a legal entity separate from its members. Whereas a corporation is structured and operated largely based upon state corporate statutes, a LLC is structured and operated in accordance with an Operating Agreement.

2. The Operating Agreement is drafted with the unique needs of the objectives of the LLC members and there are few mandatory statutory provisions (or prohibitions). In the absence of provision in the Operating Agreement, statutory default rules may apply.

3. The LLC member has four LLC interests:

a) Profits

b) Losses

c) Capital

d) Distributions

4. Each of these interests may be independently allocated to a member. Allocation depends upon the terms of the Operating Agreement and may have tax consequences.

5. Management.

a) Member managed by default.

b) Option to elect one or more managers in Articles of Formation – the public document filed with the State of Washington.

c) LLCs are generally not required to observe formalities required for corporations (*e.g.*, regular documented Board of Directors meetings and special meetings to approve of corporate activities). Good or "best" business practices, however, include memorializing important LLC business transactions.

d) Real estate investment LLCs typically are actively managed by members.

6. Generally, LLC interests are not freely transferable.

a) No securities laws registration.

b) By default, a LLC may not admit a new member without the *unanimous* consent of all LLC members. An Operating Agreement, however, may define whether a member may transfer his or her interests and under what circumstances.

B. Limited Liability.

1. A LLC member is generally not personally responsible for the debts of the LLC or torts committed by other members.

2. Exceptions: A creditor can "pierce the limited liability veil" of member managed LLC if the LLC was not adequately capitalized, the members treat the LLC as their alter ego, the members breach their fiduciary duties, or if members personally guarantee any LLC debts.

C. Tax Neutral Or Advantaged Compared With Other Forms Of Entity Ownership.

1. From a tax perspective, a LLC is either a disregarded entity or a pass-through entity. By default, a single member (or married couple) LLC is a disregarded entity and treated as a sole proprietorship. The single member reports LLC income and expenses on their personal tax return and no LLC tax accounting is required. By default, a multiple member LLC is taxed by the IRS as a partnership. The LLC prepares a partnership tax return that allocates each member's share of income, deductions, depreciation and credits to be reported on each member's personal tax return. Each member's share is reported on Schedule E for real estate profits/losses.

2. Real estate can generally be contributed and retitled into a LLC without tax on unrealized gains when changing form of ownership.

3. Although profits, losses, capital and distribution rights may be independently allocated to members, there may be additional tax issues unique to each LLC.

D. Asset Protection.

1. There may be a right to seize a LLC's distributions to the debtor-member, but the creditor can neither take over that member's LLC management role nor force a distribution.

2. The Operating Agreement is not a public document.

3. Distributions are controlled by the Operating Agreement.

E. Estate Tax Planning.

1. LLC member may gift interests, but not management rights, in a LLC.

2. If the gift is well planned, a member can transfer gifts up to $11,000 per year to any individual, to reduce the member's taxable estate. Since interests in a LLC are generally not freely transferable or marketable, the interest's gift value can be discounted, thus effectively "increasing" the amount of the gift and "reducing" the amount of the gifting member's taxable estate.

III. Disadvantages of the LLC.

A. Formation transaction costs are generally higher than a standard incorporation as a result of custom tailored Operating Agreements unique to each LLC's situation.

B. Tax accounting fees may be higher in some circumstances.

C. Annual Washington LLC fees and fees for states where the LLC transacts business.

D. If an objectives include gaining access to certain capital markets (such as venture capital) or "going public," using a LLC may not be feasible. These, however, are not usually common objectives for a LLC that will hold real estate investments.