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SHOULD YOU TRANSFER RENTALS TO AN LLC?

By Victor Sy, CPA, MBA

Limited Liability Company (LLC) is a hybrid business association that combines the advantages of a corporation with the flexibility of a partnership. They are similar to LLC's that have been used extensively in Europe and South America.

Is it time to place your real estate properties inside an LLC? Should you deed your residential or commercial rentals to an LLC? Let's explore the advantages and disadvantages of LLCs.

LLC provides the following advantages:

1. Liabilities are limited to the equity invested by each member.
2. It gives some form of liability protection for each member unlike general partnerships whose partners are also exposed personally to liabilities of all other partners.
3. There is greater flexibility in management, capital contributions, and distributions.
4. You may choose to be taxed as corporation, partnership, or disregarded entity.
5. Choosing to be taxed as a disregarded entity means less administrative and recordkeeping chores.
6. There are liberal membership qualification requirements.
7. It enjoys step-up of basis after certain transactions.

LLC also has disadvantages:

1. The statutes on LLC's are relatively new. There is confusion because different states enact different rules. It is still unclear how Tax Courts will rule on different issues.
2. Most states require that an LLC must have two members (as opposed to only one for corporations).
3. Most states require that LLC's dissolve upon death, retirement, expulsion or bankruptcy of any member unless all remaining members consent to reinstate the LLC.
4. And here is a bombshell: California LLC's must also pay an annual fee based on the company's gross income. While other states welcome this new type of organization, it seems that California was only forced to adopt LLC's statutes to stop the outflow of business into the neighboring states of Nevada and Arizona. That attitude manifests itself by making this type of entity available but punitive by taxing your gross rents and your sales price when you dispose of it.

As you can see, there is a need to plan, a need to balance the advantage of liability protection against the added burden of an entity fee. LLC's who "check the box" to file as partnerships or disregarded entities find themselves paying more taxes and fees than other forms of entity - in the name asset protection.

Here are some TIPS for you:

1. Instead of having one LLC whose gross rents or sales price exceeds $250,000, set multiple LLC's to go under the radar.
2. Consider having multiple FLP's with a common LLC that serves as a general partner.
3. Caveat: Be careful not to trigger a county tax reassessment when you make your transfer.