

# **Why the Limited Liability Company is the Top Choice for Real Property and the Corporation is Used for Businesses**

**by Mary Hanson**

Since its adoption in California in 1994, the limited liability company has become a familiar entity for ownership of real property. There are a number of good reasons to prefer the LLC as the entity for ownership of real property, and to prefer the S corporation as the entity for ownership of a business. Of course, each business and ownership situation is different. But there is a clear trend and common fact situations that support the trend.

## **Use of the LLC for ownership of investment real estate**

Here are the key reasons that the LLC is more appropriate than a corporation for the ownership of real property:

- \* The LLC is a partnership for federal tax purposes (unless other tax treatment is elected). The members (owners) in an LLC get both the benefit of protection from personal liability and the tax benefits of partnership tax law.
- \* The LLC provides the protection from personal liability to all members (including managers of the LLC), like a corporation.
- \* The general rule of “Do not hold real property in a corporation” does not apply to LLCs. While the sale of corporate property and liquidation of a corporation can generate two levels of tax on shareholders, the LLC taxed as a partnership exposes the owners to only one level of tax.
- \* Partnership tax treatment does present accounting and tax challenges for an LLC, such as the deemed liquidation of the LLC in the event the ownership changes from two or more members to one member, or if 50% or more of the ownership is transferred within a 12-month period. However, the passive investment nature of real estate allows for planning and thoughtful implementation of any change so that potential tax problems can be addressed.
- \* Real estate is most often a straightforward investment so that an interest in an LLC owning real estate is often attractive to other members and to outside investors. Being able to relatively easily determine the value and find interested buyers for an LLC ownership interest minimizes the burden of partnership tax law related to transfers.
- \* Many real estate investments avoid the gross receipts tax, which does not apply until gross receipts hit \$250,000, because gross receipts from the property are below that threshold, except in the year of sale of the property.
- \* Creditors of members of an LLC, like creditors of partners in a partnership cannot get at the assets of the LLC, and cannot step into the shoes of the member. Even a creditor who has a judgment against a member is restricted by law from taking over the membership interest in a manner that would give the creditor the same powers that the member has. Although under current law a creditor can foreclose on the interest of a member, the LLC law and operating agreement usually establish obstacles that limit the creditor to receiving only distributions from the LLC (if any), rather than real membership.

\* A creditor who has a judgment against a member of an LLC cannot take over the LLC interest of the member even after foreclosure unless the operating agreement or a majority of the other members allows the creditor to do so, while the foreclosing creditor of a shareholder of a corporation can become a shareholder of the corporation.

\* The California LLC law allows flexibility in structuring an LLC to fit the management and ownership needs of the particular investors. In contrast, corporations have a set structure determined by the California Corporations Code, with little flexibility in ownership rights and management.

\* The members of an LLC in which the only activity is ownership and leasing of investment real property (rather than dealing in real estate as a business) are not subject to the self-employment tax. An LLC used for “trade or business” activities often subjects its members to self-employment tax.

\* When the real estate owned by an LLC is sold, the tax treatment is that of liquidation of a partnership, with one level of tax on the partners, based on partnership tax law.

\* The LLC can be owned by members who are corporations, trusts, or any other type of person or entity, without disturbing the tax status of the LLC. In contrast, an S corporation can lose its status as a pass-through entity if stock in the corporation is transferred to a corporation or other type of person or entity not permitted to own S corporation stock.

### **Use of the corporation for active operating businesses**

The key reasons that the corporation is often better than the LLC for an active operating business are:

\* Many active operating businesses must have gross receipts in excess of \$250,000 just to break even. The gross receipts tax on a California LLC with gross receipts of \$250,000 to \$499,999 is \$900, in addition to the \$800 minimum franchise tax. The tax goes up to \$2,500 with gross receipts from \$500,000-\$999,999 and \$6,000 on an LLC with gross receipts of \$1,000,000-\$5,000,000. It tops out at \$11,790 on gross receipts in excess of \$5 million. These taxes are determined based on gross receipts, even if the business is not profitable, making the LLC an expensive way to do business.

\* A corporation is not subject to the California gross receipts tax. Only the net taxable income of a corporation is subject to tax, with the exception of the state minimum franchise tax of \$800, which is applied to (not in addition to) the taxes owed.

\* An S corporation pays no federal taxes and only 1.5% of net taxable income to the state of California (subject to the minimum of \$800), since the pass-through tax treatment means that the taxes on net income are paid by the shareholders.

\* An active operating business set up as an LLC may subject its members to self-employment tax. Use of a corporation avoids potential self-employment taxes, since profits distributed to the shareholders of a corporation are not subject to self-employment taxes. A common structure of the active operating business as an S corporation provides shareholder-employees with distributions of profit not subject to payroll taxes, in addition to salary and other compensation on which payroll taxes are paid.

\* If a trade or business (not real estate investment) is operated as an LLC, members can be subjected to the double whammy of self-employment taxes (the Social Security tax and the Medicare tax totaling 15.3%) on income never distributed to them.

\* Almost any type of business can be operated as a corporation. Licensed occupations and professions can operate as some type of corporation under California law.

In contrast, under California law, an LLC may not engage in any business that requires a state license, certification, or registration under the California Business and Professions Code. Thus, a business providing licensed services in construction, painting, pest control, law, architecture, accounting, landscaping, real estate sales, etc., cannot be operated as an LLC. There are just a few licensed businesses that may, under California law, be operated as an LLC because their licensing law is not part of the Business and Professions Code.

\* The corporate structure is much simpler to set up than an LLC. The corporation has a structure established by California law that is familiar to vendors, lenders, customers, and the business owners. The LLC offers flexibility in structure and tax treatment that can be valuable for tax-motivated investments and investments in appreciating assets, but may offer little advantage to the active operating business. In any event, the flexibility of the LLC comes at a price, both in the taxes it entails, and in the amount of effort required to properly set it up.

The LLC structure must be established by the participants. The type of management, decision-making authority, voting rights, the use of officers or any other representatives of the entity, transferability of ownership interests, distribution of profits, and every other aspect of the LLC operation must be determined by an operating agreement. For many issues there is no determining law or rule if the parties fail to set out the structure in the operating agreement.

Because of the burden of structuring so many different aspects of the entity, the process of creating an LLC can be too time-consuming, complicated, or burdensome for some business owners. If the tax benefits of the LLC do not seem likely to outweigh those of the S corporation, the straightforward and familiar nature of the S corporation may make the S corporation a better choice.

\* A "C" corporation can provide insurance and pension benefits to shareholder-employees with the same tax deductibility and tax treatment as any other employees. Any other type of entity does not facilitate fringe benefits for owners. Even an S corporation shareholder who is a full-time employee cannot get fringe benefits tax free if he or she owns at least 2% of the stock, and the S corporation shareholder can only get pension benefits based on income taken as compensation (not distributions of profit).

\* It is common for one owner of an active operating business to buy out other owners. The active operation of a business often leads to disagreements over liabilities, compensation, employment, expenses, marketing, and management decisions, and such disagreements often compel one owner to buy out other owners. The buyout of one or more co-owners could cause the deemed liquidation and undesirable tax consequences if the business is operated as an LLC. A corporation remains intact whether there is a substantial change of ownership or if the entity is left with only one owner.

It is necessary and appropriate to review the advantages and disadvantages of each type of entity for every new business situation, with consideration given to that business's particular facts, including ownership, control, capital investment, the nature of assets to be owned, liabilities, business plan, management, and tax circumstances. It may be helpful in any such review to consider the pros and cons of why so many real estate investments utilize the LLC and why so many active businesses utilize the corporate form.

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