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OCTOBER 2006 - CLIENT ALERT

Limited Liability Companies for Real Estate Ownership - 2006 Revisited

In recent years, IRS rulings affecting the use of limited liability companies ("LLC") have provided greater flexibility in structuring sales, exchanges and other reorganizations of real estate holdings and, in certain cases, presented the opportunity to reduce transaction costs. Recent developments in environmental contamination regulation and litigation expose owners of real property to a greater risk of uninsured liability than in the past. Many current real property financing programs require the ownership of real property by special purpose entities ("SPE"), most frequently in the form of an LLC. These and other factors have made the LLC the entity of choice for the ownership of real estate.

BACKGROUND

TAX HISTORY

Pre1996 Status of LLCs. Prior to 1996, LLCs had limited uses. The determination of whether an LLC was an association taxable as a corporation rather than as a partnership permitting "flow-through" status for federal income tax purposes was somewhat unpredictable. It required a complicated analysis involving several factual determinations, usually requiring an expensive legal opinion. Additionally, whether an LLC could have a single member was unpredictable in several jurisdictions and had an uncertain tax status. LLC use was thus expensive, cumbersome and unpredictable.

Check the Box Regulations. In 1996, the IRS issued its so called "check the box" regulations permitting taxpayers to elect to treat LLCs as either a "partnership" (in the case of more than one owner) or to "ignore the entity" for income tax purposes (in the case of a single owner). These regulations permitted a taxpayer to treat a single member LLC as if it did not exist for income tax purposes. Subsequently, the IRS formally extended "ignore the entity" status to married couples.

IRS Rulings Providing Flexibility in Like-Kind Exchanges. In 2003, the IRS issued new rulings, primarily affecting the use of single member LLCs in like-kind exchanges. In one Private Letter Ruling, the IRS permitted the acquisition of replacement real estate in a deferred like-kind exchange (a so called Starker transaction) by a newly formed LLC solely owned by the taxpayer rather than by a deed directly to the taxpayer. This Ruling permitted the avoidance of exposing the purchaser to the risks associated with individual ownership even for a moment and eliminated transaction costs and tax risks associated with a subsequent transfer to an LLC. Another Private Letter Ruling permitted the acquisition of a single member LLC owned by another (rather than acquiring the real property itself) as constituting qualified replacement property for relinquished real property in a like-kind exchange. This latter Ruling specifically sanctions the use of this type of transaction to avoid the payment of state real estate transfer taxes.

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ENVIRONMENTAL HISTORY

Because of extensive claims experience and extensive litigation, insurers of property owners eliminated coverage for damages caused by mold and other forms of environmental contamination. More recently, insurers have eliminated coverage for damages caused by bacteria and other pathogens as well. Mold and other biohazard litigation has exposed many property owners to large uninsured damage claims.

Liability associated with injuries caused by exposure to lead paint has become commonplace. In 1999, the Wisconsin Supreme Court issued a decision determining that no insurance coverage was afforded property owners for liability from tenants injured by exposure to lead paint. *Peace ex rel. Lerner v. Northwestern Nat. Ins. Co.*, 228 Wis.2d 106, 596 N.W.2d 429 (1999). This decision left many owners of property with lead paint personally exposed to large uninsured damage claims. Several law firms specialize in bringing suits on behalf of injured tenants.

As recently as December 5, 2005, the Milwaukee Journal Sentinel published a front page article about the woes of a property owner whose tenant suffers from lead paint injuries. On the same day, the Milwaukee Journal Sentinel published an editorial advocating additional steps which might be taken by the City of Milwaukee to remedy the lead paint problem.

Regulation and litigation associated with property contaminated by substances other than biological substances has proliferated.

FINANCING HISTORY

In making loans with commercial real estate as collateral, lenders are increasingly concerned about commingling the collateral securing loans with other assets and liabilities and borrowers filing bankruptcy. Bankruptcy causes substantial delays in enforcement of the lender's loans because the real estate collateral becomes consolidated with the borrower's other assets and liabilities and the borrower's other bankruptcy issues. With this in mind, many lenders require the collateral to be held by a SPE whose sole purpose is to own the collateral. The purpose of this SPE is to have the entity which owns the collateral be "bankruptcy remote". Being "bankruptcy remote" does not necessarily prevent bankruptcy, rather it makes filing less likely, and if bankruptcy is filed, less difficult and time consuming. LLCs are particularly suitable to being "bankruptcy remote" SPEs.

In recent years, mortgage backed securities, common for many years in residential lending, have become commonplace in commercial lending. Many commercial loans are now bundled into pools of loans and sold to investors. Such loans, in order to meet underwriting criteria of the agencies which rate the mortgage backed securities, must be a "bankruptcy remote" SPE. In order to be "bankruptcy remote", generally an independent member, or a "springing member", who springs to authority over the affairs of the SPE in the case of default, makes the decision as to whether or not to file bankruptcy. The decision of this independent member or springing member presumably would be made independently of the other affairs of the owners of the LLC. The effect is that bankruptcy becomes less likely and bankruptcy of the owners of the SPE would not necessarily be followed by bankruptcy of the LLC.

ADVANTAGES OF USING LLCs FOR REAL PROPERTY OWNERSHIP

There are many tax, business and financing advantages of owning real property in an LLC. Among them are the following:

TAX CONSIDERATIONS

Single Member LLC Ignored for Income Tax Purposes. Under the IRS “check the box regulations”, real property may be owned by a single member LLC which is ignored for income tax purposes. Thus, the owner may be afforded liability protection available to the corporate form of ownership while the LLC is effectively ignored for income tax purposes. This permits flow-through of taxable income to the individual as if the LLC did not exist. The result in the case of an individual is that taxable income from operations of real estate are reported directly on Schedule E of the taxpayer’s Form 1040, the same treatment as if the property were owned individually. This eliminates the requirement of an entity income tax return as well as other tax attributes and complications associated with entity ownership of assets. Similarly, single member LLCs owned by corporations, trusts and partnerships do not require the reporting of income on a separate entity tax return. Essentially, single member LLCs permit the best of both worlds, insulation from liability and no tax compliance costs.

LLCs Having More Than One Member Are “Flow-through” Entities Treated As Partnerships. LLCs with more than one member generally will elect to be treated as a partnership. This permits “flow-through” of income to its members rather than income being taxed at the entity level, thus avoiding double taxation inherent in corporations. While such an LLC will require a partnership information return to be filed, such a return is generally required in any event in the case of multiple owners of real estate. Thus, LLCs with more than one member have the advantage of flow-through status of partnerships but insulation of liability attendant to corporations.

No Stock Structure and Shareholder Limitations as in an “S” Corporation. S corporations require only one class of stock whereas an LLC may classify ownership interests with virtually limitless variations. There may be several classes of ownership in an LLC which would be prohibited in an S corporation.

Special Allocations. LLCs have flexibility in the allocation of income, gain and losses among the members as would be permitted in the case of a partnership. Special allocations are allowed.

Savings on Tax Compliance. The use of single member LLCs presents an opportunity to save tax compliance expense where real property is to be owned by multiple owners and the owners wish to avail themselves of the LLC form of ownership. Ordinarily, real property owned by an LLC with more than one member (other than the spouse of the taxpayer) would report its income as a partnership and thus may be required to file a partnership information return. In certain cases where each owner owns a proportionate share of the real property in their own single member LLC, as an example as tenants in common, a partnership return might be avoided. The availability of this technique is enhanced by recent IRS rulings permitting up to 35 parties to own fractional interests in real property as tenants in common while still avoiding partnership status.

NON-TAX CONSIDERATIONS

Avoiding Tort Claims. Properly done, an LLC should shield the individual owners from tort claims not caused by the owner of the LLC, thus insulating non-culpable owners from such liability.

Avoiding Contractual Liabilities. An LLC will generally shield owners from contractual liability unless the individual owner specifically assumes or agrees to pay the liability.

Continuation Upon Death of Member. Under a properly drafted LLC operating agreement, the business of an LLC may continue in the event of the death of a member.

Biological Contamination. Mold and other biological contamination has become a significant source of concern for real property owners. Costs of remediation can, in unusual cases, exceed the value of the property, and tenants or other occupants are more frequently making claims for debilitating diseases associated with exposure to these contaminants. Under most casualty policies, no insurance coverage is afforded for remediation necessitated by contamination by mold, fungus or bacteria. An LLC should shield non-culpable owners from such liability.

Other Environmental Contamination. An LLC should provide some insulation from exposure to either environmental remediation costs or liability for personal injury or property damage associated with environmental contamination. As an example, some owners are discovering long after their purchase of real property that their groundwater has been contaminated by activities conducted on land adjacent to theirs. Such a discovery may render a property, in effect, unmarketable until it is cleaned up and that clean up may take several years. It may also expose an owner to clean up costs in certain instances.

Avoiding Liens and Encumbrances. In the case of financially distressed individuals, liens and judgments would ordinarily encumber property and effectively prevent its conveyance. Real property owned by an LLC, even if there are judgments and liens against an individual owner, would not be subject to such liens and encumbrances. While distributions from the LLC may be encumbered by a creditor's action, such creditor would presumably have no voice in the management of the LLC authorizing such distributions.

Management Decisions. Members may participate in the management of an LLC and an operating agreement may provide flexibility in management and decision making. Controls can be placed over certain decisions for a certain period of time or upon the occurrence of certain events. Formal board approval for many transactions is not required as in corporations. In a limited partnership, on the other hand, participation in management may void the limited liability afforded by limited partnerships to its limited partners.

Estate Planning. For estate planning or other purposes, real property may be transferred to a trust simply by assigning the member's interest in the LLC, thus, avoiding the transaction costs normally associated with the transfer of the title to the real property.

Partial Transfers. A partial interest in real property may be transferred simply by transferring a fraction of a member's interest in an LLC by sale or otherwise, thus avoiding the requirement to transfer title to the real property. This minimizes transaction costs associated with such a transfer.

Privacy. The true owners of an LLC are not a matter of public record.

A So Called "Due on Sale" Clause Contained in Most Mortgage Financing Instruments may be Partially Avoided. Most mortgage instruments contain a "due on sale" clause prohibiting transfer or sale of the encumbered real property. A prohibited transfer would constitute a default under the mortgage. Many mortgage instruments include within the definition of such prohibited transactions a transfer of control of the entity owning the real property but would permit non-control transferring transactions. Some lenders which have more broad prohibitions on transfer of ownership interests in entities owning such real property will permit a modification of their mortgage instruments to permit such non-control transfers. Thus, a partial sale of property by transferring a non-controlling interest in the LLC of, say, 49% of the LLC may be permitted without creating a default or necessitating refinancing. This is particularly important in an escalating interest rate environment where favorable financing is in place. Also, refinance costs and prepaying penalties can be avoided.



A Prohibition Upon Subsequent Encumbrances may be Partially Avoided. Some mortgage financing instruments prohibit subsequent encumbrances, including subordinated mortgages. The ability to obtain additional funds for development or other purposes where such mortgage financing is already in place may be limited because of such a prohibition. Obtaining additional investors or financing may be more easily facilitated by the LLC form of ownership because a potential investor or lender may be given an equity ownership in the LLC or a lender may collateralize its interest by obtaining a security interest in the member's interest in the LLC. Such techniques may be unavailable for real property owned individually.

Cost Considerations. If it may be considered as such, one disadvantage of the LLC form of ownership is the cost associated with the formation and maintenance of the LLC. Such costs include legal costs of preparing the necessary articles of formation, the operating agreement, filing fees and annual maintenance fees. These costs may be substantial when many properties are owned and it is desired to have a separate LLC for each property. Such costs, while not unavoidable, may be limited. Delaware and recently Illinois have established serial limited liability companies. These states permit the establishment of a series of members, managers or LLC interests having separate rights, powers and duties with respect to specific property or obligations. Each series could have a separate business purpose and thus own separate parcels of real property. It would provide the same protections which would be available by forming separate limited liability companies for each property. The Delaware and Illinois Acts provide for reduced filing fees and annual fee structure for each series formed after the initial filing than would be the case in forming many individual LLCs.

The information contained in this letter is general and while it is intended to provide useful background information to our clients, it is not legal advice and should not be relied upon in any specific instance or for any specific matter. Please obtain legal advice prior to taking any action in respect to matters discussed in this letter.

We hope that you have found this information helpful. If you have any questions or need assistance with matters relating to the subject matter of this letter or other tax, real estate or business matters, we would be pleased to assist you.