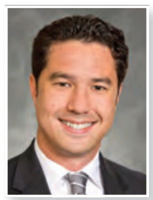
Pros and cons of holding rental properties through LLC

LEGAL *EASE*

By Jon Hasebe

In recent years, real estate investors prefer to hold title to their rental properties in limited liability companies to other types of corporate entity. Limited liability companies provide a number of benefits to real estate investors, including, limitation of personal liability, pass-through taxation, and ease of use. Nevertheless, property owners who want to utilize the limited liability company to hold title to their rental properties should be aware that there are drawbacks with this approach.



One of the biggest advantages in using a limited liability company to hold title to property is, unsurprisingly, limiting the liability of the members of the LLC. Provided that members adhere to the formalities set forth by the state of Arizona, they are not personally liable to the debts of the LLC. In other words, when a property owner holds title individually to a property, they put their personal assets at risk in the event a claim is made in connection with the property. If a tenant tripped and fell on a wobbly step, the tenant could make a claim against the property owner personally, which may result in the property owner's assets being placed at risk. If the property was instead owned by an LLC, the personal assets of the members of the LLC would be insulated by the LLC and the tenant could only make a claim against the assets owned by the LLC.

Another benefit of using a limited liability company to hold rental properties is the avoidance of double taxation. Unlike a traditional c-corporation, an LLC is classified as a "disregarded entity" for tax purposes. In other words, if a rental property is owned by a single-member LLC, any income or capital gains generated by that LLC that are distributed to the member would be treated the same as if the member held title to the property individually. In contrast, if a c-corporation were to hold title to a rental property, any income or capital gains would be taxed at the corporate level and any dividends to the shareholders would also be taxed, hence the dreaded "double taxation." In the event that an LLC that holds title to a rental property has multiple members, the IRS will treat that LLC similar to a partnership. Profits and losses are passed through to each of its members who will then be responsible for reporting their share of the profits and losses on their respective individual income tax returns.

Another major advantage of using an LLC to hold rental property is the ease of use. Arizona provides more flexibility to limited liability companies in how they are set up and may operate. Unlike the strict formalities set forth in the statutes for corporations, the duties, powers, rights, and conduct of the affairs of an LLC and its members may be adopted in an operating agreement. The operating agreement is essentially a contract among the company and its members and allows the company and its members flexibility in regards to how it addresses issues such as transferability of shares, distribution of profits, voting rights, and management of the company.

Despite the advantages associated with holding rental properties through a limited liability company, there may be several drawbacks, which might prevent landlords from holding their properties in LLCs. First, is cost. Organizing an LLC and keeping it in good standing can be costly. While boilerplate operating agreements can be found online, this one-size-fits-all approach may cause more problems then it solves, especially when dealing with multiple members.

A second drawback is permissibility. If the property has been financed, whether or not the property can be transferred to an LLC will almost always be up to the lender. If the lender consents to the transfer, the property owner should be prepared to sign a personal guaranty, which will keep them on the hook for any obligations arising under the loan.

Another drawback is the requirement of disciplined management. As mentioned above, *provided that members adhere to the formalities set forth by the state of Arizona*, they are not personally liable to the debts of the LLC. Members of the LLC have to be careful not to commingle the assets of the LLC with their personal assets.

The LLC should apply for its own employer identification number and bank accounts and the members should make sure to keep records of any actions taken by the LLC. Failing to keep distance between the actions of a company and the actions of its members could open the members up to a veil piercing action that would allow them to be personally sued in addition to the company, which would defeat one of the main advantages of holding the property in an LLC.

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