

This article is for informational purposes only. Nothing in this article should be understood as legal advice, and no attorney-client relationship is created by it or the information it contains. Consult with a licensed attorney if you require assistance in a legal matter. This article is protected by United States copyright law and may not be reproduced, distributed, transmitted, displayed, published or broadcast without the prior written permission of the Burton Law Firm. You may not alter or remove any trademark, copyright or other notice from copies of the content.

Limited Liability Companies for Investment Management

1. Introduction

Whether starting a new business or reorganizing an existing business, one of the most important decisions an entrepreneur will make regards the form the business will take. Given the wide variety of business forms, such as corporations and sole proprietorships, it can be difficult to choose between them. The limited liability company, commonly known as an LLC, has become a popular option.

2. Advantages of the LLC Form

Liability Protection

The limited liability company provides an obvious advantage due to the limited liability nature of the form, which can protect members from liability for the torts and debts of the company. The typical LLC has no shareholders or board of directors. Instead, an LLC has members or partners who have contributed something, whether capital or labor or assets, to the formation of the LLC. The member's liability is limited to the extent of his or her equity investment in the LLC. In this regard, the LLC and the corporation are similar.

Asset Management

Unlike a corporation, however, the ownership structure of an LLC will generally make a member's ownership interest less valuable to creditors and other parties. The member owns an interest in the LLC but does not own the assets of the LLC itself. Therefore, the creditor can only access the member's interest, which may be of little value if there are restrictions on the transfer of memberships. This means that a member may be able to use an LLC to protect his or her assets from creditors.

Real Property Management

The LLC form works well in real property management. The liability limitations discussed above work in concert with transferring real property ownership to an LLC as a valid business strategy. Using an LLC allows the real property to be owned by the business, rather than by the members. This provides a continuity and durational stability in business operations that minimizes the effect on real estate management of any future change in LLC membership.

For example, assume a landlord owns several properties and operates as a sole proprietorship. If the landlord decides to retire, he or she must transfer title ownership of the properties to the new owner, incurring transfer and recording fees. Using an LLC, however, the landlord may simply divest him or herself of membership in the LLC, as the LLC owns the real property. In this hypothetical situation, the LLC continues to operate smoothly during the transition and after the original member is gone.

The same result can be produced if two people own a single piece of real property and lease it out. Both owners can transfer ownership to an LLC, and each person would retain the same proportional share in the LLC that they held in the property beforehand. The LLC would rent the property to the tenant. Then, if one of the two members decides to sell his or her interest while the other wants to retain an interest, the property need not undergo a partition action to accommodate them both. The first member simply sells his or her interest with no interruption of the current lease.

Estate Planning

An LLC can also act as part of a comprehensive estate plan. A testator who owns an LLC membership interest will generally find it hard to liquidate this interest, and the selling price for such an interest will be low. In long-term planning, the membership interest usually possesses greater value if it is retained by the testator-member, since the LLC will continue to operate and generate income for the member in the future. The member can then devise fractionalized interests in his or her membership. If the LLC operating agreement allows it, the member may divide the membership into as many parts as he or she desires. At the member's death, the fractionalized interests are distributed, generally subject to the terms of the LLC's operating agreement, and the LLC continues to function, generating more income for the devisees than if the member had sold his or her interests outright.

The LLC is also useful in devising large properties since the interests in the property need not be divided. Instead, the LLC holds the properties and the testator simply devises or fractionalizes his or her membership interest or shares

in interest in the LLC. The property remains undivided and control of the property has passed to the next generation.

Gifted Shares

The LLC form allows for the ability to retain control of property while still being able to present vast quantities of the property's value as gifts. The current gift tax exclusion is at \$12,000 per person, per year. Using an LLC, a member who wants to make a donative transfer can gift a share of their LLC membership interest, rather than the interest itself. If such share is valued at less than \$12,000 the transfer may be made without incurring gift tax. This allows for a long-term gifting strategy which minimizes the tax implications of the gifts. Furthermore, for gift tax purposes there may be a discount in value for the membership shares or interests transferred by minority interest shareholders.

3. Disadvantages of the LLC

Expense

As with all business forms, starting an LLC requires an initial investment of time and money. Attorney fees to set up the LLC and filing fees required by the state are the typical expenses associated with starting an LLC. Furthermore, just as in a corporation or other business form, the LLC must plan for the day to day expenses of operating a business for profit, including employee salaries, facility maintenance costs, and insurance premiums.

Time/Effort

While not as rigid as a corporation, the recordkeeping requirements of an LLC are still substantial. In forming the LLC, members will sign an operating agreement and they must follow the procedures as laid out in this agreement. The operating agreement should specify which members are permitted to perform which acts on behalf of the LLC. Especially important for real property management situations, it should be absolutely clear who can sign leases with tenants.

As with any business, income and expenses should be tracked carefully. The operating agreement will generally provide for an accounting method and recordkeeping requirements. One of the most difficult aspects of keeping records for an LLC involves tracking "Capital/Member Accounts." These accounts reflect the value of the membership interest of each member and include the

liabilities of the LLC, capital contributions of members, and income distributions by the LLC.

Duration/Permanence

The difficulty in selling and encumbering membership interests in the LLC can be a double edged sword. If a member wants to divest his or her interests in the LLC, the two most common options available are to sell to another member or find an outside buyer.

The selling member is more likely to find a willing buyer among the existing members. The existing member is familiar with the company, its operations, and can readily assess the value of the selling member's interests. Furthermore, there are generally fewer restrictions on such sales.

Selling to an outside buyer presents a greater difficulty. First of all, as part of an asset protection strategy the LLC's operating agreement may apply a "poison pill" to any transfers of membership interests to outsiders. This "poison pill" can include a limitation on transfers, a first right of refusal in other members, a transfer penalty, or some other limitation. After crossing the hurdle of the "poison pill," the buyer must be willing to accept the LLC's operating guidelines and limitations. The reasoning for these guidelines is not always clear to an outsider, so the addition of an outsider will generally require a familiarization period where the outsider becomes integrated into the business operations of the company.

These aspects of the LLC form can make it difficult for a member to transfer interests in the LLC to a specific person chosen by the member. The member may have to obtain the consent of all other members before transferring an interest to any person, thus defeating the freedom of the member to alienate his or her interest in the LLC.

Loss of Tax Deductions

Another disadvantage of the LLC affects the taxation of LLC members. Generally, lower income investors, who earn under \$150,000 annually, may qualify to deduct certain portions of their business losses on rental activity during a taxable year. However, if the member holds the rent-producing property in an LLC, the member will likely lose these loss deductions under Internal Revenue Code Section 469.

4. Conclusion

Using an LLC may help a business and its owners protect themselves from liability and improve the stability of the company. But the LLC has its drawbacks, as well. You should consult with a qualified attorney to help determine if the LLC is the right answer for your business.

555 University Ave,
Suite #275,
Sacramento, CA 95825

