

## **The Use of Limited Liability Companies in Real Estate**

### **Should You Form an LLC for Your Next Venture?**

By James S. Arico

April 2003

For real estate purposes, many principles of limited partnerships and limited liability companies (LLCs) are the same. Real estate limited partnerships usually have a developer/real estate professional as the general partner with the project investors as the limited partners. The general partner exercises control over the construction, development, marketing, operation and sale of the project. The limited partners have no management control over project construction, development, marketing, operation or sale of the project. The liability exposure of these limited partners is restricted to the amount of their investments (assuming the limited partnership is adequately capitalized). Similarly, real estate LLCs typically have a developer/real estate professional as the manager with the project investors being the members. The manager exercises control over all aspects of the project. The members have no management control over day-to-day operations. Liability exposure is limited to the amount of investment by each member (again assuming the LLC is adequately capitalized).

The major difference between the limited partnership and the LLC is the liability exposure to the limited partnership's general partner versus the LLC's manager. The limited partnership's general partner is individually liable for the debts and obligations of the limited partnership. Conversely, the LLC's manager, much like an officer or director of a corporation, is not individually liable for the debts and obligations of the LLC. Thus, for the builder/ real estate professional, the absence of general liability exposure to the LLC manager makes the LLC entity an

extremely popular choice for investment, development and operation. However, with the continued increase in the LLC gross receipts tax (as listed in California Revenue and Taxation Code §17942(a)), which can cost an LLC as much as \$11,790 per year, many developers and real estate investment professionals are reconsidering the limited partnership model and appointing a limited liability entity (a corporation or an LLC) as the general partner.

#### *Lender Mandated Single Purpose Entities*

A new source of funding for commercial real estate ventures arose in the 1990s and remains a favorite source of funding today. Wall Street investment banking firms (in conjunction with mortgage lenders, real estate professionals and real estate governing bodies) developed a process which originates loans that are then purchased, packaged and subsequently resold as investment vehicles, much like corporate bonds. The ultimate source of the individual loan funds is not the original lender. This originating lender merely acts as a conduit for the delivery of funds, hence the term “conduit financing.”

Conduit financing lenders and, more recently, some institutional lenders are requiring their borrowers to form single purpose entities (“SPE”) or single purpose vehicles (“SPV”) in order to obtain real estate financing. The form of SPE used is normally a limited partnership or an LLC, whose sole purpose is owning and managing or developing and selling the real estate project that is the subject of the financing. The formation of an SPE from the lender’s perspective compartmentalizes a borrower’s economic activity and corresponding liability to the project which is the subject of the loan and limits the exposure of the project to the borrower’s other creditors or casualty liabilities from other projects.

Therefore, the borrower is isolated from unrelated activities that may impair the flow of project revenues to the lender.

#### *So - Is An LLC Right For Your Next Venture?*

The use of the LLC, both in general real estate ventures and for lender mandated

single purpose entities, has grown in popularity since the implementation of the Act. Is the use of an LLC right for you? A number of factors must be considered by you, your fellow investors, your real estate professional as well as your legal and tax advisors. The type of transaction, the allocation of profit and loss, the number and types of investors, the willingness to maintain corporate records, the anticipated annual gross receipts of the proposed project as well as the size of the project are just a few of the factors to consider. The real estate practice group at Clark & Trevithick would be happy to sit down and discuss these issues with you and your tax professional to determine the correct entity for your next real estate venture.

1 Fred T. Witt, Jr., Esq., Single-member LLCs, 53rd Institute on Federal Taxation, Outlined No. 3, Part II, page 3.

**READER ALERT.** As of January 1, 2003, California Revenue and Taxation Code § 18662(e) requires a withholding of 3-1/3 percent of the gross sales price when an individual sells California real property. The withholding amount is submitted to the California Franchise Tax Board and used as a credit against the seller's California state income tax owed. Failure to properly withhold will result in a penalty equal to the greater of \$500 or 10% of the amount required to be withheld. While exemptions are allowed for the sale of a principal residence, sales below \$100,000, like kind exchanges and other types of transactions, there is no withholding for certain non-individual sellers, such as corporations with a permanent place of business in California, California limited partnerships, or California LLCs. If you personally hold title to real property in California and are considering selling that property, you should consult real estate and tax counsel before marketing your property.