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Is a Limited Liability Company (LLC) Right For You?

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One of the first challenges faced by individuals establishing a business is deciding whether to do business under a separate business entity. Many landlords have not thought of renting property as a business, but landlording is a business. If you are a sole proprietorship and you may not be protect you from unlimited claims. This is because a business has no separate legal existence apart from its sole proprietor owner. If you are sued for wrongful eviction or wrongful death, the property which this occurred at is just one of the assets which can be affected by these very expensive claims. All property owned in your name, and any other assets are up for grabs. To protect yourself from these expensive claims, you can limit your liability to a specific property. For example, you own a 16-unit apartment building, but you also own several other pieces of property. By creating an LLC and placing the 16-unit apartment building into that LLC, when claims arise from that building, the only assets are the building itself (and whatever else you choose to put into that LLC). Claims against the LLC are "limited" to the assets of the LLC. Assets in your personal name, spouse's name or business partner's name cannot not be touched, except in very limited circumstances. (See Piercing the Corporate Veil below).

To understand what an LLC is, you must also understand what a corporation is. A corporation is a legal entity recognized as separate and apart from its owners (shareholders). A corporation is formed by filing articles of incorporation with the state and drafting bylaws for its operation. A corporation is treated as a separate entity or person from its owners and even has its own Federal tax identification number, similar to an individual's social security number.

An LLC is similar to a corporation in that it is a legal entity recognized as separate and apart from its owners and offers the same limited liability protections for its owners. However, LLCs are easier to operate because they do not have the same formalities required of corporations. The LLC is also formed by filing articles of organization with the state and drafting an operating agreement for its operation. An LLC also obtains a Federal Tax

identification number. Like shareholders of a corporation, an LLC's owners have limited personal liability. However, an improperly formed or operated LLC may be disregarded by the court causing its owners to be personally liable. (See Piercing the Corporate Veil below.)

Piercing the Corporate Veil

"Piercing the Corporate Veil" is a concept where the courts disregard the corporation and allow the owners to be personally liable. However, this can only occur when the LLC was improperly formed or operated, i.e. for fraudulent purposes.

How is an LLC Taxed?

That all depends, because when an LLC is formed, the LLC elects whether it wants to be taxed as a corporation or a partnership. When the LLC has only one member, it can be a "disregarded entity" and is treated like a sole proprietorship for tax purposes. Real Estate activities are usually treated as a partnership if it has multiple owners or a sole proprietorship if it is a single member LLC.

The federal government does not tax LLCs that are treated as partnerships or sole proprietorships. An LLC that has multiple members files a partnership return (Form 1065 and the profits or losses "flow-through" to the members based on the percentages they are entitled to pursuant to their member agreement). A sole proprietorship requires "Schedule C" or in the case of a rental property "Schedule E" to be attached to the individual's Form 1040. The net LLC taxable income is included with the taxpayer's other taxable income and only one level of tax is paid. However, sole proprietors that file Schedule C, or active partners (see IRC §469) in a non-rental activity will be subject to self-employment and Medicare tax in addition to income tax.

Although the federal government does not assess a separate income tax on LLCs, the State of California does! This tax is over and above the $800 minimum franchise tax that California charges an LLC annually (corporations and limited partnerships also pay an $800 annual fee). California charges a "gross receipts" fee on LLCs once an LLC has gross receipts in excess of $250,000. Please note that the fee is on the ***receipts gross*** and not net taxable income. In other words, an LLC that has gross receipts of $1,000,000 yet posts a loss will stay pay California a $6,000 fee. Please note that only the net profit on the sale of an asset is considered gross receipts; however, the entire sales price of inventory is considered gross receipts. It is crucial that the LLC has an understanding of the difference between assets and inventory.

Finally, forming an LLC outside of California will not escape either California fee if the business activity is located inside California.

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This article has provided an overview of the taxation and liability issues involved with LLCs for real estate activities. It should not be used as a definitive source of choosing this type of entity. If you are considering using an LLC for your real estate activities, discuss your liability issues with an attorney and your taxation issues with your CPA.