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COMMENTARY

Limited Liability Companies Offer Advantages to R.E. Titleholders

By Bryan S. MacCormack

THERE ARE A NUMBER OF WAYS to hold title to real estate. Some of the most common forms that are used are the nominee trust, the corporation and the limited liability company.

The use of a "nominee trust" is a common vehicle to hold title to real estate, but there is a popular misconception that nominee trusts provide some form of liability and/or asset protection. In fact, most nominee trusts simply create a principal/agency relationship, and the trustee does not have the authority to act without the direction and consent of the beneficiaries. From a liability and asset protection standpoint, owning your real estate in a nominee trust provides you with no greater protection than owning the property in your name individually. Nominee trusts do offer some degree of privacy because the schedule of beneficiaries does not have to be recorded with the registry of deeds. Additionally, for estate planning purposes nominee trusts are typically recommended when clients wish to make gifts of fractional interests in property each year without having to record a deed in each instance.

Most corporations are classified as either a C or an S corporation. Both types of corporations insulate owners from personal liability for debts of the enterprise. In addition to offering limited liability, an S corporation has the advantage of flow through taxation,



BRYAN S. MACCORMACK
is an attorney
who practices in the areas of
real estate, taxation,
corporate transactions and
estate planning. Visit his
firm's website @
www.maccormacklaw.com

meaning the income would not be taxed at the corporate level and then again at the shareholder level as with a C corporation. The income of an S corporation would be reported only once on the owner's individual income tax return.

As a general rule, by transferring your real estate to a corporation you will protect your other assets from claims of the corporation's creditors. However, a primary drawback is that a corporation is required to recognize gain on a non-liquidating distribution of appreciated property in an amount equal to the difference between the property's fair market value and its adjusted basis. As an example, let's assume a corporation

owns a piece of property valued at \$500,000, with a \$100,000 adjusted cost basis. If the corporation distributes the property to its sole shareholder, the distribution from the corporation will be considered a sale of the property by the corporation. The corporation would recognize \$400,000 of gain on the distribution.

Also, adding new shareholders to an existing corporation has significant adverse income tax costs. Upon the receipt of shares in a corporation, the recipient would recognize ordinary income in an amount equal to the difference between the fair market value and the amount paid for the shares.

Flexibility of LLCs

Limited liability companies offer flexibility in types of ownership. There are two types of interests that you may acquire in an LLC, a capital interest and a profits interest. A capital interest is an interest that would give the member a share of proceeds if the LLC's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation. A profits interest is an interest other than a capital interest and entitles an owner to a share of profits and losses from operations of the company. The receipt of a capital interest for services provided to the LLC is taxable as compensation to the new member. Conversely, the receipt of a profits interest does not have any income tax

consequences to the LLC or the new member.

The issuance of a profits interest provides an excellent way to retain key personnel without incurring the additional income tax liabilities associated with the issuance of shares in a corporation.

Like a corporation, an LLC provides members and managers with limited liability for the entity's debts and claims. The Massachusetts LLC statute provides that the debts, obligations and liabilities of the LLC, shall be the obligations of the LLC alone, and that no member or manager of the LLC shall be obligated personally for any such debt solely by reason of being a member or acting as a manager of the LLC. Similar to an S corporation, the income of an LLC is not taxed at the entity level, but will pass through to the members and be reported on their individual income tax returns.

If you have multiple pieces of property in a single Massachusetts LLC, each property will not be protected in the event of a claim arising from another property in the LLC. Your personal assets would be protected from any such claim; however, all of the assets

and/or real estate in the LLC would be subject to the claim. In other words, in order to protect each piece of property from claims that arise out of and relate to the operation of any other property, separate LLCs would be necessary. The problem with separate LLCs is that in Massachusetts there is a \$500 annual filing fee for each LLC. Additionally, accounting costs may increase because of the potential for multiple tax filings.

The Delaware Series LLC may offer a solution. By statute, if separate and distinct records are maintained for each series (property), then the debts, liabilities, and obligations incurred with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the LLC generally, or any other series thereof. In other words, each piece of property will be protected from claims arising from other properties. To obtain this benefit, the Certificate of Formation would identify the entity as a Series LLC, and each property must be separately titled and accounted for. Each property would be transferred to a separate nominee realty trust. For asset and liability

protection, a separate single-member Massachusetts LLC would serve as trustee of each nominee trust, and serve no other purpose. In 2003 Massachusetts amended its LLC statute to allow single-member LLCs. In order to be recognized in Massachusetts, you must register the Delaware LLC with the Corporations Division of the Massachusetts Secretary of State's office by filing an application for registration as a foreign LLC.

LLCs offer an advantageous form of doing business because its members do not need to adhere to the corporate formalities such as keeping minutes of meetings or holding annual meetings. The organizing document of the LLC is known as the "operating agreement" and most of the statutory provisions can be overridden as the parties desire. LLCs are flexible in terms of income taxation, types of owners, limited liability protection for members and managers, and flexibility in capitalization and allocations. The operating flexibility, limited liability, and freedom from corporation income tax make the LLC an attractive way to hold title to your real estate holdings. ■