

# Using LLCs to Purchase Rental Property

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# Nalli, Elias & Associates, PC

## ABOUT THE FIRM

- Founded in 2007 by Michael W. Nalli, Esq.
- Practice Area focuses include: Estate Planning, Estate Administration, Elder Law, Real Estate, and Small Business Formation and Governance



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# Introduction – LLCs for Real Estate Investment

- A Limited Liability Company (LLC) is a flexible business form that maintains some of the attributes of both a corporation and a partnership.
- LLCs provide limited liability for the owners of the business, like a corporation; . . .
- while, at the same time, offering pass-through taxation, like a partnership.
- Additionally, an LLC is a “creature of statute”, like a corporation; . . .
- but, is an “agreement based” business, like a partnership.
- The LLC’s Operating Agreement may be tailored to fit a great number of structures that suit the needs of family businesses, passive investments, silent partnerships, joint ventures, or even businesses that intend to operate with a more formal structure, akin to a corporation.
- The dual benefits of limited liability and pass-through taxation, along with, the ability to tailor the business structure to the needs of the owners/investors, make LLCs an excellent option for real estate investment.
- During this presentation, we will discuss practical legal considerations and steps to ensure that you, or your clients, maximize the benefits of the LLC business form in real estate investment.



# Pros and Cons of Rental Properties in an LLC

## Pros

- Liability Protection
  - “Piercing the Veil”
  - Personal Guarantees
- Pass-through Taxation
  - Taxed as partnership
  - Taxed as S. Corp.
- Estate Planning
  - Continuity and Probate Avoidance
  - Trust v. LLC

## Cons

- Administrative Requirements
  - Filing requirements
  - Bookkeeping and reporting requirements
- Administrative Costs
  - LLC Formation
  - Yearly meetings and regular filings
- Transfer Taxes
  - State law dependent
  - LLC is a separate legal entity



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# LLC v. Limited Liability Insurance

## LLC

- LLC owns the real estate; would have to transfer already owned real assets into the new entity to have legal protection
- Financial and economic administrative costs
- Protects personal assets completely
  - (**CAVEAT:** piercing the veil)
- Limits personal liability to investment in the LLC
- With Real Estate, personal guarantees may still be required
- LLC should still carry liability insurance to protect business assets

## Limited Liability Insurance

- Does not alter legal status of real estate ownership
- No additional administrative commitments
- General Business Liability Policy
- Umbrella Liability Policy
- Personal assets only protected up to liability limits
- Insurance Company may provide legal defense up to liability limits
- Once insurance limits are “maxed out”, however, there is unlimited personal liability



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# Pass-Through Taxation for LLCs

- All income from the LLC passes through to the Member(s) personal tax rates
- Amount of profit to be reinvested in business a tax consideration
- Can be taxed as a sole proprietorship (disregarded entity), but still need an EIN Number
- Quarterly Tax Payments for single member LLC
- Can be taxed as a partnership with K-1s
- Can elect to be taxed as a C corporation (lose pass-through taxation), or an S. Corp.
- If the LLC will have employees, such as maintenance or property managers (possibly even the owners), being taxed as a corporation can be advantageous
- Real Estate Rentals are treated as Passive Activity Income – even if you manage the property, you will only be able to deduct losses against the income from the rentals; i.e., you will not be able to use losses from rental properties as a write off against other income, such as wages. This is to avoid using real estate investment purely as a tax shelter.





# Asset Protection, Generally

- Creating an LLC **DOES NOT** limit your business liability
- Creating an LLC **DOES** protect personal assets and limit individual liability exposure to the amount invested in the business
- However, personal guarantees are common with real estate purchase financing, i.e., banks will often require the Members of the LLC, and their spouses, do sign a personal guarantee for purchase money financing
- Piercing the Veil is another legal means for petitioning a court to remove the mantle of protection from personal liability
- Must follow “corporate formalities” to avoid piercing the veil, such as, keeping business and personal accounts separate, preparing business reports, and conducting yearly meetings
- A judgment creditor may be able to get a Charging Order against the LLC, which will give the holder priority ahead of the Members of the LLC when assets are sold, and this can be a particular issue with sole member LLCs
- Even with the veil of asset protection, it is advisable for an LLC to also maintain general liability insurance
- Some real estate investors recommend a separate LLC for each rental property, since the liability protection does not extend to the assets of the business, and thus, an accident on one property could require the sale of other rental properties. However, this risk must be balanced against the additional financial and economic costs of operating multiple LLCs. Another reason to have insurance on every property.



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# Rental Property Liability Considerations

- Liability to Tenants – Warranty of Habitability
- Liability to Tenants – Damage to Property
- Residential v. Commercial Property
- Patent Defects on the Property
- Latent Defects on the Property
- Attractive Nuisances
- Activities of Tenants – Dangerous or Illegal Activity
- Slip and Fall Accidents
- Other Premises Liability
- Licensees v. Invitees



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# LLC v. S. Corp.

- Subchapter S. Corp. the initial business entity to allow pass-through taxation and limited liability
- S. Corp.'s limited by restrictions on number of shareholders and types of shareholders, so that the advantages primarily benefited small businesses
- LLCs created to provide more flexibility, while maintaining pass-through taxation and limited liability:
  - Number of investors
  - Types of investors
  - Foreign investors
- LLC can elect to be taxed as an S. Corp.
- For a time, there was a preference toward S. Corps. amongst attorneys based upon the legal predictability of a more established bank of caselaw, however, this has largely gone away as LLCs have been mainstream for over two decades now
- S. Corp. may provide some advantages for businesses with employees, and accordingly it is recommended that real estate businesses with multiple employees elect to be taxed as an S. Corp.



# LLC formation and governance checklist

- Certificate of Organization
- EIN Number
- Tax Election
- Operating Agreement
- Organizational Meeting
- Membership Certificates (???)
- Certificate of Authority
- Special Meetings
- Yearly Meetings
- Retain an Accountant for Bookkeeping and Taxes
- Obtain Liability Insurance
- Comply with State Registrations, Licensure Requirements, and Reporting Obligations



# Member-Managed or Manager-Managed

## Member-Managed

- Preferred where all Members will be active in operating the business
- If limits on authority of Members, state specifically in the Operating Agreement
- Otherwise, all Members will be able to bind the company in contract
- Some states do not presume that Members have the authority to transfer property, must state authority in Operating Agreement and file a Certificate of Authority by name

## Manager-Managed

- Preferred for business where all Members want to share the profits, but one or a few Member(s) will actually run the business – many family businesses
- Manager may be a Member, or could be an outside professional
- Manager may be paid – whether Member or not
- Carefully define Manager's authority, AND the limits thereto in Operating Agreement
- File Certificate of Authority for “Manager”



# Drafting the Operating Agreement

- Operating Agreement should NOT be one-size-fits-all
- Okay to start with a template, but must always take into account the specific needs of each client, as well as, state-specific laws, etc.
- In recitals, explicitly state the date the Certificate of Organization was filed with the state, and the entity “effective date” if differs from the entity filing date
- State the principal place of business
- Express that the Operating Agreement sets forth all of the terms between the Members regarding operation of the Company, and set forth procedure for amending the Operating Agreement
- Define the role of Members – active or passive?
- Define how Members will share profits
- Discuss Capital Contributions and Capital Accounts of Members, as well as, the impact of Member loans to the company
- Carefully consider voting requirements for: a.) day-to-day operation; b.) transfer of assets; and, c.) debt limits, etc. – simple majority, super majority, or other
- Define Management – Members or Manager?
- If Manager, discuss how selected, term, how replaced, and the parameters of the Manager’s authority to act on behalf of the Company



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# Drafting the operating agreement (continued)

- Define requirements for calling a special meeting, the timing of yearly meetings, and the rules for conduct of a meeting, including establishing a quorum, the presiding officer, voting rules, remote participation
- Explicitly state the reporting requirements of the company and the individual or position responsible for preparation and distribution of said reports
- Watch out for overly burdensome reporting requirements; i.e., only list requirements that you intend to fulfill – piercing the veil concerns
- Dispute Resolution Provisions – especially for family businesses and if the LLC is at least in-part an estate planning vehicle
- For attorneys - clarify in the Operating Agreement that the LLC was your client, that you do not represent individual Members, and that all of the signatory Members had the opportunity to review the Operating Agreement with counsel of their choosing. This is especially important with small businesses, where some Members make the faulty assumption that you represent their individual interests
- Have the Operating Agreement signed by all original Members, and have a signature page signed by any additional Members added after formation



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# Transferring Title in Real Estate to an LLC

- New Investments v. Previously Owned Real Estate
- Separate LLC for each property?
- Title Search
- Tax Lien Search
- Agreement of Sale
- Financing
- Deed – Must be deeded to the LLC as Title Owner of the property to have legal liability protection
- Transfer Tax





# Ongoing considerations . . .

- Duration of the LLC – Perpetual or a set time-period?
- Dissociation triggers
- Winding up the Business
- Succession Planning
- Transfer of Membership Interests
  - Valuing the Membership Interests
  - Right-of-first-Refusal?
  - Financing and Transfer Logistics
  - Economic Interest v. Voting Interest
  - Adoption of Operating Agreement
- Restrictions on Transferability
  - Permissible Transferees
  - Family only? What about spouses?
- Sale of Assets – Capital Gains



**Thank you for your attention!**

Please let me know of any questions or points for clarification.

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