Forming and LLC to Purchase Real Estate – Common Oversights

By Emmanuel G. Fournaris

I.) Choice of Entity

A limited liability company (an "LLC") is a state law entity that is created and operated in Delaware pursuant to the Limited Liability Company Act, 6 Del. C. Section 18-101 et seq. (the "LLC Act"). From a drafting perspective, the LLC is a very flexible entity. The LLC Act is structured as a "default statute" (i.e., unless the parties agree otherwise, or unless the LLC Agreement provides otherwise). This allows the parties to an LLC Agreement to have a lot of flexibility in how they structure their LLC Agreement. See 6 Del. C. Section 18-1101(b), states that "it is the policy of this Chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." This is in contrast to the General Corporation Law of the State of Delaware (the "Corporate Act"), where the provisions tend to be more mandatory and less flexible (i.e. the parties shall do this).

From an income tax perspective, the LLC is also very flexible. If the LLC has only one member, it can elect to be taxed as a disregarded entity (i.e. a sole proprietorship that reports income/ losses on a Schedule E to IRS Form 1040), as a "C" corporation (IRS Form 1120) or an "S" corporation (IRS Form 1120S). If the LLC has more than one member, it can elect to be taxed as a partnership (IRS Form 1065), as a "C" corporation (IRS Form 1120) or as a "S" corporation (IRS Form 1120S).

Under the IRS rules, the default tax classification for an LLC with only one member is a disregarded entity and for an LLC with two or more members the default tax classification is a partnership. If the LLC wants to make an election to be taxed as a corporation ("S" or "C"), it must do so on IRS Form 8832 (copy attached).

Big Mistake: Never take title to real estate in a corporation- whether it is a "C" or "S" corporation. The preferred vehicle for owning real estate is an LLC taxed as a

disregarded entity (if the LLC has only one member) or an LLC taxed as a partnership (if the LLC has two or more members).

Both corporations and LLCs taxed as corporations provide their shareholders/ members with limited liability protection to the same extent as an LLC taxed as a disregarded entity or a partnership. The reason for using an LLC taxed as either a disregarded entity or a partnership is primarily tax driven.

I have attached a "Choice Entity Chart" prepared by Robert R. Keatinge, dated February 18, 2014, that discusses the tax treatment of various types of entities (copy attached). Although there is a 2019 version of the entity chart, that contains the current changes to tax law, I was not able to get a copy of the most recent version. If you subscribe to Mr. Keatinge's service, you can get the most recent version of this entity chart. In any case, this version is still helpful in distinguishing the tax attributes and treatments of various entities. In reviewing this entity chart, the LLC taxed as a partnership or sole proprietorship is the preferred vehicle or owning real estate.

Key Factors:

1. Basis increases from guaranty of entity debt
2. Distribution of appreciated assets without triggering gain
3. Special allocations of G/L versus allocations based on ownership percentage.
4. Basis increase of underlying assets at death/ transfer by making an IRC§754 election.

II.) Realty Transfer Tax

The Delaware realty transfer tax provides that every person who presents for recording any "document" shall be subject to pay a realty transfer tax with respect to the transaction. The current realty transfer rate is four percent (4%) of the value of the property represented by the document. 30 Del. C. Section 5402 (copy attached). Depending upon where the property is located, this tax is shared between the state and local government.

A "document" is broadly defined under the statute and means any deed, instrument or writing whereby any real estate, or interest in real estate, shall be sold, transferred or otherwise conveyed from the grantor to the grantee. 30 Del. C. Section 5401(1). A "transfer" means any transfer made by a "document." See, 30 Del. C. Section 5401(9)(e).

Although the statue defines which transfers of real estate might trigger a realty transfer tax, there are lots of exceptions to the realty transfer tax laws in the State of Delaware. See 30 Del. C. Section 5401(a)-(x). For example, (a) transfers of real estate by will; (b) transfers of real estate between a husband and wife, a parent and a child or the spouse of a child, or between siblings and half-siblings; (c) transfers to a trustee or nominee of the grantor; and (d) transfers to a corporation or an LLC where the grantor own stock of the corporation or an interest in the LLC in the same proportion as the grantor's interest in the real estate being conveyed; etc.

Big Mistake: Don't think that only conveyances by deed will trigger a realty transfer tax in Delaware. Section 30 Del. C. Section 5401(8) imposes a realty transfer tax where beneficial ownership in real estate is transferred through a conveyance or series of conveyance of intangible interests in a LLC.

Why is this an issue? Because there are a lot of people who do not follow this rule, either because of ignorance or because they intentionally do not file a "document"

and pay the tax. For example, if my wife and I own an LLC that owns real estate and we transfer our LLC units to our neighbors for value, a 4% realty transfer tax will be triggered even though the real estate is still owned by the same LLC.

Attached is a copy of a realty transfer tax return that gets filed with the New Castle County Recorder of Deeds when a document is recorded with respect to property being transferred in New Castle County. There are similar forms for Kent and Sussex Counties. This form is used regardless of whether you are transferring title to real property directly by deed or indirectly through the transfer of an intangible interest in an entity that owns real estate.

There are several exceptions to this rule. For example:

a) A pledge of ownership interest in an LLC is not a transfer.
b) Any conveyance of an interest in the LLC where the grantor and the grantee fall within any of the exceptions contained in paragraphs 30 Del. C. Section 5401(1).
c) Where the beneficial owners of the real property prior to the conveyance or series of conveyances own 80% or more of the beneficial interest in the real estate following said conveyance or series of conveyances. 30 Del. C. Section 5401(8)(c).
d) Where the beneficial owners of real property prior to the conveyance or series of conveyances own less than 80% of the beneficial interest in the real estate following said conveyance or series of conveyances, unless under the Realty Transfer Tax Regulations promulgated by the Delaware Secretary of Finance, such transfer(s) are properly characterized as a sale of real property. 30 Del. C. Section 5401(8)(c)(copy attached).
e) In making this determination, the Secretary of Finance will look at the following factors:
    i.) The timing of the transaction;

ii.) The beneficial ownership of the real property or the LLC before and after the conveyance(s);

iii.) The business purpose for the LLC; and

iv.) Any other relevant factors.

On December 18, 1986, the Department of Finance issued Technical Information Memorandum 86-9. The purpose of this Memo was to give guidance with respect to 30 Del. C. Section 5401(8). A copy is attached.

Remember, if 80% or more of the beneficial owners of the LLC or the real estate are the same before and after the conveyance(s), then no realty transfer tax is due. If less than 80% of the beneficial owners of the LLC of the real estate after the conveyance, then you need to look at the above factors to determine if the transfers should be properly characterized as a sale of real property.

When analyzing these factors, consideration needs to be given to the following:

a) <u>The Timing of the Transaction</u>. If the LLC is newly created, a strong presumption arises that the transfer was a sale of real property.
b) <u>Percentage Change in Interest</u>. If there is a more than 50% change in ownership within a 12 month period, there is a presumption that a sale of real property occurred.
c) <u>Transitory Ownership Status</u>. The transitory status of a member of an LLC suggests that the transfer is subject to taxation.
d) <u>Business Purpose</u>. This is the most important test. If the business purpose for the transfer is more significant than the conveyance of the beneficial ownership in the LLC, than the transfer will not be subject to taxation.

III.) Ownership of Multiple Properties- Series LLC versus Wheel and Spoke Structure

Under Delaware law, an LLC may be organized with a "series" of members, managers, membership interests and/or assets. 6 Del. C. Section 18-215. For clarification purposes, I will refer to the master entity as the "Series LLC" and the separate series created within the Master Entity as "Segregated Cells" or "Protected Cells." Each Protected Cell may be established with separate ownership, separate assets and separate liabilities from those of each of the other Protected Cells created within the Series LLC of which it is a Protected Cell. Any such Protected Cell may have separate rights, power or duties with respect to specified property or obligations and any such Protected Cells may have a separate business purpose or investment objectives. If organized and operated properly, the assets of each Protected Cell is protected or insulated from the liabilities of the other Protected Cells and the assets of Protected Cells are not required to be applied to satisfy the obligation of the other Protected Cells established with the Series LLC.

The concept of the Series LLCs raise many questions of state law and tax law. From a state law perspective, it is unclear whether the segregation of the assets of a Protected Cell will be respected in other states that have not adopted a Series LLC statute. From a tax perspective, it is unclear whether a Series LLC with more than one Protected Cell will be treated as one (1) taxable entity or whether each Protected Cell will be treated as a separate taxable entity.

6 Del. C. Section 18-215(b) sets forth that the following factors are needed to create a Series LLC under Delaware law:

a.) The LLC Agreement must provide for the establishment of one (1) or more Protected Cells;
b.) Each Protected Cell must maintain "separate" records from the other Protected Cells;

c.) The Certificate of Formation for the LLC must provide notice of the limitation on liabilities of a Protected Cell. (See copy attached.)

With regard to the taxation of Series LLCs, the IRS has ruled that:

a.) A Series LLC having a single owner that does not make an election to be treated otherwise, will be disregarded as an entity separate from its owner.
b.) A Series LLC having more than one (1) owner will be treated as a partnership, unless it elects to be treated otherwise.

Examples:

1. Series LLC has three members- A, B and C. Series LLC creates two Protected Cells- Y and Z. Both Protected Cells are owned equally by A, B and C. Result: Series LLC will be treated as a partnership and Protected Cells Y and Z will be treated as disregarded entities.
2. Series LLC has three members- A, B and C. Series LLC created two Protected Cells- Y and Z. Protected Cell Y is owned equally by A and B and Protected Cell Z is owned solely by C. Results: Protected Cell Y will be taxed as a partnership and Protected Cell Z will be taxed as a disregarded entity.

There is not much authority out there right now that sets forth exactly what a Series LLC must do to ensure separateness among its Protected Cells. Neither the statute nor case law specifically spell out exactly how much separateness is needed to obtain the benefits of a Series LLC under 6 Del. C. Section 215. In addition, there are still a lot of states that do not recognize the Series LLC concept. So if you form a Delaware Series LLC to own Pennsylvania real estate, will a court in Pennsylvania respect the Delaware Series LLC structure? It should based on the Full Faith and Credit Clause of the US Constitution, but we won't know for sure until it is tested. Sometimes states will use "public policy" arguments to find a reason for not enforcing another state's laws in their state.

There is also a lot of uncertainty with Series LLCs in the banking world, the insurance world, the licensing world, etc. Until Delaware recently created the Registered Series LLC (See, 6 Del. C. Section 218), you couldn't even get a certificate of good standing for a Protected Cell separate from the Series LLC that created the Protected Cell.

Why are people using Series LLCs? My guess is because you only have to pay one (1) franchise tax for the Series LLC and the Protected Cells are not subject to a separate franchise tax? I don't really know the answer to that question for certain, but it surely seems that way.

<u>Big Mistake</u>: Do not put all of your real estate in one (1) LLC. In my practice, I will not use a Series LLC to own real estate because I am not confident that I can achieve separate liability protection among the Protected Cells. I prefer to use what I call a "wheel and spoke" structure.

When a client owns multiple properties and wants to take title to those properties in an LLC for liability protection purpose, estate planning purposes, or to avoid an ancillary administration of an estate if the client dies owning real estate in another state, you have several options:

a.) You can title each property in a separate LLC. The problem with this approach is that you will pay a separate franchise tax for each LLC and also prepare and file a separate income tax return for each LLC.
b.) You can title each property in separate Protected Cells created by a Series LLC. The problem with this approach is the uncertainty as to liability protection among the Protected Cells even though you are only paying one franchise tax. In addition, depending upon how the Protected Cells are owned, you may need to prepare and file separate income tax returns for Protected Cells.
c.) You can create a wheel and spoke structure by forming a "Master LLC" that is owned by the client and his family and taxed as a partnership and then create

several single member LLCs ("SMLLCs") owned 100% by the Master LLC to take title to the separate properties. Under this approach, you will have to pay multiple franchise taxes (one for each LLC, including the SMLLCs), but you will have more certainty as to asset protection and you only have to prepare and file one (1) income tax return for the Master LLC since the SMLLCs are disregarded tax entities.

When setting up a "wheel and spoke" structure, you must follow certain formalities if you want the benefits of separate liability protection:

a.) Title the real estate in the name of the SMLLC.
b.) Make sure your insurance policy lists the SMLLC as the owner of the property. You can add the Master LLC as an additional insured if you like.
c.) All leases for the property should list the SMLLC as the owner/landlord, and not the Master LLC.
d.) For banking purposes, the single member can obtain a separate taxpayer identification number and bank account. It is not required to do so since it is a disregarded tax entity, but it is helpful for both accounting and separateness purposes.

In fairness to Series LLCs, I have used them effectively in certain practice areas where there is not a lot of liability exposure. The genesis of the Series LLC dealt with a problem that Fidelity Investments had. Fidelity Investments only had one (1) state law charter, but owned and operated many separate and distinct mutual funds. The Series LLC was created in Delaware to address Fidelity Investments' desire to keep the assets and liabilities of various mutual funds separate, while still operating under one (1) state law charter.

In my practice we have used Series LLCs in the following instances:

a.) Private captive insurance companies; and

b.) When we have trusts that cannot be separated and we have beneficiaries that have different investment objectives.

IV.) Drafting LLC Agreements

Almost every practitioner starts with some type of form document when drafting an LLC Agreement. Form documents are good tools used by lawyers because they create uniformity and cost efficiencies that you can pass on to clients. They can also help you think through the terms of a deal. However, using a form LLC Agreement is not an excuse for being lazy or not thinking through the specific terms of your deal.

Big Mistake: Do not be a slave to a form document!

As we discussed earlier, the LLC Act gives maximum effect to the principle of freedom of contract and to the enforceability of the terms of an LLC Agreement. 6 Del. C. Section 18-1101(b). This means practitioners have tremendous flexibility in terms of how they can draft their LLC Agreements. I am going to touch on a few LLC matters where I see practitioners default to the language in their form LLC Agreement and fail to really think through the terms of their client's specific deal.

1. Additional Capital Call. After the LLC is formed and each member has made his/her initial capital contribution, the LLC has a need for additional capital. What does the LLC Agreement provide?

   a. No Additional Capital Contributions. No Member shall be required to make any further or additional capital contributions to the Company, except as required by the Act or this Agreement. No Member shall have the right to make additional capital contributions to the Company, except as approved by the Managers.

b. Capital Call Provisions. If at any time (or from time to time) additional funds in excess of the initial capital contributions ("Required Additional Capital Contributions") are required by the Company for or in respect of any of its obligations, expenses, costs or liabilities (including, but not limited to, payment of operating expenses and any reserves that the Manager deems necessary or appropriate), the Manager may notify each Member of such fact and request that each Member make a Required Additional Capital Contribution to the Company (pro rata, in proportion to each Member's respective Company interest) in the aggregate of the total amount of funds required. Each capital call shall specify the reason and related expenses of such capital call. Each Member shall be obligated to make its Required Additional Capital Contributions within forty-five (45) days after the delivery of the Manager's notice. Such funds shall be deemed to be additional capital contributions of the Members and shall increase the Members' respective capital accounts. Once the aggregate Required Additional Capital Contributions have reached ________ Thousand Dollars ($__,000), any capital call must be approved by the unanimous vote of the Members.

2. Management. How will managerial decisions be made by the LLC? Will the LLC be member or manager managed? What will be the voting requirements for making decisions? Will the LLC Agreement require a majority vote of the members? Will the LLC Agreement require a unanimous or "super majority" of the members for certain significant LLC actions (i.e., add a new member, sell property, borrow money, etc.). If manager managed, how will managers be selected? How will they be removed? These are all questions that an attorney needs to discuss with his/her client before drafting the LLC Agreement.

    a. Majority Vote of Managers. The Managers shall collectively, but not severally, have all of the powers of the Company and may exercise all of the

rights and powers of a manager under the Act. Unless otherwise specified in this Agreement, a majority vote in number of the Managers with respect to any item of business shall be the act and decision of the Company; and the phrase "approved by the Managers" as used in this Agreement shall mean such a decision and only such a decision. No Manager shall have the right, privilege or power to perform any act on behalf of the Company, unless such act has been approved by the Managers. In the event there is a deadlock among the Managers over the conduct or management of the Company business or Company Property, such deadlock shall be decided by a vote of all of the Members, including any Managers who are Members, and the decision of such Members owning a majority of the Company interest, as represented by the number of Units owned by those Members shall be binding on the Company.

b. Significant LLC Actions. Notwithstanding anything to the contrary contained in this Agreement, the Managers shall not, unless it has been approved by a majority vote of all of the Members as determined by their Company Interest, take any of the following actions:

(a) To change the nature of the Company's business;

(b) To sell, assign, convey, lease, mortgage or otherwise dispose of or deal with all or any part of the Company Property, including, but not limited to, the power and right to utilize all or any part of the Company Property as collateral for any indebtedness.

(c) To issue additional Company interests, create new classes of Company interests or admit additional or new Members;

(d) To make any capital expenditures in excess of One Hundred Thousand Dollars ($100,000;);

(e) To borrow any money that exceeds One Hundred Thousand Dollars ($100,000) on behalf of the Company from third parties, Members, or affiliates of Members, mortgage or subject to any pledge, security interest or other security instrument any of the assets of the Company, or prepay, in whole or in part, refinance, increase, modify, consolidated or extend any obligation of the Company in excess of $100,000;

(f) To dissolve or liquidate the Company;

(g) To amend this Agreement;

(h) To approve a transfer of a Company interests;

(i) To determine the fair market value of a Company interest on behalf of the Company for purposes of determining the purchase price in any transfer of a Company interest;

(j) To sell all or substantially all of the assets of the Company; and

(k) To merge, consolidate, amalgamate, recapitalize, reorganize or affect any other business combination of the Company with or into any other Person.

c. Manager Selection. The initial Managers of the Company shall be [Member1] and [Member2] (the "Initial Managers"). At the death, resignation or removal of either of the Initial Managers, the remaining Initial Manager shall then be the sole Manager of the Company. At the death, resignation or removal of the last surviving Initial Manager, the Members shall elect a new Manager(s) by an affirmative vote of the Members owning more than fifty percent (50%) of the Company interest as represented by the number of Units owned by the Members. Upon election, the new Manager(s) shall have such rights, powers and duties as provided for by this Agreement. In the event the Members do not elect a new Manager(s), then the management of the Company shall be with the Members and a majority vote of the Members as represented by the

number of Units owned by the Members shall be the act and decision of the Company.

d. Manager Removal (without cause). A Manager may resign as a manager of the Company at any time by giving at least ninety (90) days prior written notice to all of the other Managers and the Members. A Manager may be removed by the Members for any reason or no reason at all.

e. Manager Removal (for cause). A Manager may resign as a manager of the Company at any time by giving at least ninety (90) days prior written notice to all of the other Managers and the Members. A Manager may not be removed, except for acts of gross negligence or fraud in connection with the performance of the Manager's duties under this Agreement.

3. Economic Rights of the Members. How are LLC profits and losses shared? Unless you are dealing with promotors and profits interests, members almost always share LLC profits and losses based upon the member's respective ownership interest in the LLC.

   a. Allocation of Profits and Losses. Except as otherwise required by applicable federal tax laws, all items of income, gain, loss, deduction or credit of the Company shall be allocated among the Members in proportion to their Company interests; provided, however, that for federal income tax purposes such items of income, gain, loss and deduction or credit with respect to property contributed by a Member to the Company shall be allocated between the Members so as to take account of the variation between the federal income tax basis of the property to the Company and its fair market value at the time of its contribution to the Company in accordance with applicable federal tax laws.

How are LLC “cash” distributions made? Who decides if and when cash distributions are made? How are “cash” distributions calculated?

Distribution of Net Cash. Following the end of each fiscal year of the Company and the adjustment of the Member’s capital accounts for that fiscal year, the Company shall distribute the Net Cash of the Company to the Members as approved by the Managers. Distributions of Net Cash shall be made among the Members in proportion to their Company interests. The term “Net Cash” shall mean an amount which is equal to the net profits of the Company, plus the net proceeds from any refinancing of Company Property, except that (a) depreciation of buildings, improvements, personal property and amortization of leasehold improvements, if applicable, shall not be considered a deduction, (b) repayment of principal of debts shall be considered a deduction, (c) any amounts expended on behalf of the Company by the Managers for capital improvements or new investments shall be considered a deduction, and (d) if the Managers find it necessary or advisable or required by applicable law, a reasonable reserve shall be deducted for capital needs to provide a reserve to be invested in additional Company Property, to provide funds for improvements, or for any other contingency of the Company.

4. Transfer Restrictions. Absent an agreement to the contrary, a member can transfer his/ her LLC interest to whomever he/she wants. Therefore, it is very important that the LLC Agreement contain “buy-sell” language that is specifically tailored to the business or purpose of the LLC. Transfer restrictions for an LLC that owns and operates a business are significantly different than transfer restrictions for an LLC that owns a passive investment in real estate.

   When drafting transfer restrictions in an LLC Agreement, you need to clearly define (i) what constitutes an event of transfer (i.e. death, bankruptcy, divorce, etc.); (ii) what happens when a transfer event occurs (i.e. is there a mandatory

buyout, an option, a put or just a right of first refusal); (iii) if a buyout of a member occurs, how will the purchase price be determined (i.e. by appraisal, by formula or by agreement); and (iv) how will the purchase price be paid (i.e. cash at closing, installment note, etc.)? If the purchase price is to be paid in installments, what are the terms of the promissory note? Remember, if a buyout of a member occurs, it is usually not a “good” event. The more specific and detailed the LLC Agreement can be; the less likely a dispute will arise between the buyer and the seller (or his/her family) when negotiating these buyout terms.

5. Permitted Transfers. This is truly a very problematic area. Should a member have the right to transfer his/her LLC interest to another member, his/her spouse, a lineal descendant or a trust created for the transferring member and/or his/her spouse and lineal descendants? If permitted transfers are allowed, will the transferees be full voting members or just be assignees who are along for the “economic right.”

   Permitted Transfers. Notwithstanding anything contained in this Agreement to the contrary, a Member shall have the right to transfer all or any part of his Company interest to another Member or to a transferee that bears one (1) of the following relationships to the Transferring Member: a spouse, a lineal descendant or a trust created for the primary benefit of the Transferring Member and/or the Transferring Member’s spouse or lineal descendant(s). The transfer of a Company interest by a Member to one (1) of the above permitted transferees shall cause the transferee to be admitted as a Member of the Company without any further act or consent on the part of the Company or the Members provided the transferee complies with the provisions of Section 10.4 of this Agreement.

6. Amending the LLC Agreement. This is a provision that I find frequently overlooked in negotiations among parties forming an LLC. How is the LLC Agreement amended? Is the unanimous vote of the members and managers

required? Will it simply require a majority vote or a super majority vote of the members and managers? Are you going to let one (1) member hold up a significant change to the LLC agreement? Are you going to let the majority member run "rough shod" over all the other members?

Entire Agreement. This writing represents the entire agreement and understanding of the parties with respect to the subject matter of this Agreement and supersedes all prior and contemporaneous agreements and understandings of such parties in connection with this Agreement. Unless otherwise expressly provided in this Agreement, this Agreement may not be amended or modified except by written agreement signed by each of the then parties to this Agreement.

Remember, most clients who read an LLC agreement do not know what they do not know. Unless you discuss these issues with the clients and explain to them their options, they will not be able to make an informed decision. The answer in most cases is that every deal is different and these types of significant issues need to be analyzed in the context of the deal and discussed with the client. It is a big mistake to treat your form LLC agreement as a "one shoe fits all" agreement.

Also a problem if the same members have different agreements for different properties. This can cause inconsistent treatment among members.