Will LLCs be Obsolete for Holding Real Estate?

by Fred B. Weil & Christopher A. Karachale

Limited liability companies have been a good choice for real estate held for investment. Even a corporate business owner, who also owns the real estate that houses his or her business, often keeps the real estate outside the corporation as a separate investment.

Among the many proposals for tax reform has come a proposal sponsored by Rep. Dave Camp (R-MI), Chairman of the House Ways and Means Committee, that would radically change the desirability of limited liability companies for these purposes. Substantial deference will be given to the view of the Chairman, particularly in a year when "tax reform" is on the table, so this bill should be taken seriously.

Limited liability companies have been advantageous vehicles because they provide centralized management of the property, are taxed as partnerships (which means that all gains are taxed to the owners), and permit nearly complete flexibility in moving real estate between the entity and the owners without taxation. In this regard, S corporations have similar advantages, but with one key disadvantage: a transfer of appreciated property out of the S corporation into the hands of its owners is a taxable event to those owners.

Limited partnerships have also been frequently used to provide benefits similar to those of a limited liability company, but the structure has always been more complicated because of the desire that the general partner not be subject to personal liability. This concern regarding personal liability led to the formation of corporate general partners and issues regarding the capitalization of the general partner, the amount of ownership of a general partner needed to have for the limited partnership to be recognized as such, etc. In fact, in large measure the advent of the LLC was a response to the disadvantages of S corporations and limited partnerships.

Among the property holding devices generally thought to be less desirable was the tenancy in common. Problems connected with the use of a tenancy in common include the risk that one unhappy owner might force a sale of the property through a suit for partition, questions about what kinds of restrictions on owner rights may turn the arrangement into a partnership for tax or liability purposes, difficulties in dealing with the property in the event that one of the owners dies, and the general lack of flexibility in transferring real property interests as compared to transferring ownership interests in a limited liability company.

Mr. Camp's bill would change the picture. The Ways and Means Discussion Draft of Tax Reform Act of 2013 would treat all pass-through entities, partnerships, limited liability companies and S corporations in the same manner for tax purposes. See Subtitle C, Section 231. The key change for partnerships and limited liability companies is that *any distribution of an appreciated asset would be treated as a sale by the pass-through entity* (just as is the treatment of distributions from S corporations under current law), resulting in the owners being taxed on that gain.

One possible result of this change would be the revival of tenancies in common as the vehicle for holding title to real property. Other vehicles may emerge, such as certain types of land trusts similar to those used in Illinois, that might escape the statutory definition of a pass-through entity.

Will this radical change make it through Congress? Obviously, we don't know that at this point. But we will keep an eye on this aspect of "tax reform" as proposals for reform and revenue make their way through Congress and report developments to you. Meanwhile, the prudent thing for those who now own land as individuals or in tenancies in common may be to sit tight and do nothing until there is more clarity.

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