

LIMITED LIABILITY COMPANIES IN UTAH

By David W. Steffensen
448 East 6400 South, Suite 450
Salt Lake City, Utah 84107
801-263-1122
email: dave@dwslaw.net

I. ADVANTAGEOUS USES OF LLC's.

A. To Hold Real Property.

LLC's are an excellent vehicle for acquiring, holding, developing and selling real estate.

Consequently many LLC's have been formed by developers to carry out their development activities and also by real estate investors to acquire and operate their real estate holdings.

Prior to the availability of the LLC, most real estate activity was conducted through the use of limited partnerships. Limited partnerships provided limited liability protection for most of the investors of the real estate project. But the limited partnership does not provide limited liability protection to the general partner. In addition, limited partnerships avoid the tax pitfalls of using corporations. With Subchapter C corporations, for example, any attempt to distribute the appreciation associated with real estate is double taxed. Even with Subchapter S corporations, it is impossible to get the appreciation associated with the real estate out of the corporate entity without taxing the appreciation once.

In contrast, the limited partnership affords partnership tax treatment to its investor/owners, which is advantageous because appreciated property can be distributed out of the partnership entity to the individual partners with no tax event. See I.R.C. Section 731(a). That inherent tax advantage over the tax treatment of corporations, combined with the ability of limited partnerships to provide special allocations to partners, create various classes of ownership, avoid

"inside" versus "outside" debt/basis problems, provide inside basis adjustments to protect new owners entering existing partnerships, and allow entities other than individuals to act as owners, made the limited partnership the entity of choice for real estate development prior to the advent of the LLC.

Now, with the availability of the LLC, there is often no advantage in using a limited partnership. If properly organized, the LLC will be characterized as a partnership for tax purposes and gain all of the tax advantages associated therewith. The LLC then provides the additional benefit of limited liability protection to all of its owners. Consequently, the LLC avoids the inherent problem of having a general partner who is personally and fully liable for all of the debts and risk associated with the entity's assets and business operations. Another advantage of an LLC over a limited partnership is that limited partners in the limited partnership format cannot participate in management of the entity without losing their limited liability protection. Limited partners in limited partnerships are therefore not only deprived of an opportunity of participating in the management of the business enterprise but also forced into per se passive investor status in the enterprise under the Passive Activity Loss rules. In contrast, a member of an LLC may participate in the management in the entity without any impact on the limited liability protection he or she enjoys. Consequently, members of an LLC who participate in management can avoid having their proportionate share of the LLC's income and loss characterized as passive income or loss under the Passive Activity Loss rules. That change, combined with the change in the Passive Activity Loss rules to allow real estate developers who are traders and dealers in real property to characterize their income and loss activities as "active," has made the LLC the entity of choice for many real estate developers.

B. To Hold Tangible Personal Property or Intangible Assets.

An LLC may also be formed to hold tangible personal property or business property. A family

LLC created to hold tangible personal property may provide an effective vehicle for holding and gifting extensive tangible personal property holdings. An LLC formed to hold and lease business property can often be an effective technique where it is disadvantageous to hold all of a particular business' assets in one entity. For example, LLC subsidiaries of S corporations may be formed without creating a group of affiliated corporations that would undermine the S corporation's "S" status or without having to form "subchapter S subsidiaries." Importantly, taxpayers must remember that under the new CTB regulations, entities formed solely to hold personal use assets are ignored for tax purposes. Personal use assets may therefore be placed in such LLC subsidiaries for liability purposes but will be "transparent" for tax purposes.

In addition, an LLC may be an effective vehicle to develop and exploit intellectual property or other intangible assets. For example, one recently organized LLC involved two members who formed an LLC with the objective of developing copyrighted materials owned by one of the members. The authoring member contributed his copyright to the LLC in exchange for a fifty percent interest in the LLC and a royalty based on sale of the copyrighted materials. The other member contributed cash. The LLC then paid a royalty to the authoring member (which royalty should not be subject to self employment tax) and then divided the rest of its income between the two members (which income probably is subject to self employment tax).