

Key Considerations for Owning Investment Real Estate in an LLC and Navigating 1031 Exchanges

Many conversations with real estate investors who call us as an exchange Qualified Intermediary start with an inquiry such as, “My investment property is owned in an LLC. Is there anything special for me to consider regarding my 1031 Exchange?” There are many considerations for issues that arise from real estate owned in an LLC.

What is an LLC?

It is common knowledge that “LLC” is an acronym for Limited Liability Company. A Limited Liability Company is a business structure specifically authorized by state statute, and the rules in each state vary. However, there are some commonalities that cross state lines. For example, the owners of the LLC are called “members.” A properly structured and operated LLC protects its members from being personally pursued for any of the LLC’s debts or liabilities. There are two main types of LLCs, single-member LLC and multi-member LLC. A single-member LLC, often abbreviated as “SMLLC”, is a disregarded entity. As a disregarded entity, it is treated as a “pass-through” entity for income tax purposes, and all income and losses are reflected on the member’s personal income tax return. A multi-member LLC is a legal partnership and is itself a Taxpayer that must file its own income tax return. The profits and losses in a multi-member LLC are shared among the members, proportionate to their investments in the LLC. For example, if one member contributed 50% of the start-up capital, another contributed 30%, and the remaining member contributed 20%, the profits and losses will be allocated proportionate to their contributions. Some states offer Series LLCs, which have some economies to offer when multiple LLCs are needed.

Maintaining LLC Status

To maintain the protections afforded by the LLC structure, the LLC members must comply with a variety of state rules. Typically, these include holding annual member meetings, paying annual LLC fees to the Secretary of State, maintaining an in state registered agent, keeping business and personal finances separate, avoiding the use of business funds for personal expenses, and complying with the entity’s Operating Agreement. Additionally, Multi-Member LLCs will have an Employer Identification Number (EIN), which is required for the necessary tax reporting for a partnership. A Single-Member LLC is not required to obtain an EIN, but is permitted to do so if the member so chooses. Further, if a real estate acquisition is funded with a bank loan, even for a single-member LLC, banking regulations require that the LLC have an EIN. Failure to comply with the rules the state imposes on LLCs could result in “piercing the corporate veil” and allowing creditors to have access to the members’ personal assets for satisfaction of debts and liabilities.

Implications of Owning Investment Real Estate in an LLC

To understand the implications of owning investment real estate within an LLC, the first thing that must be determined is whether the LLC is a single-member or multi-member LLC. This determination is important because of the Same Taxpayer Rule, which mandates that the Taxpayer who sells the Relinquished Property(ies) must be the same Taxpayer that acquires the Replacement Property(ies), and the classification of the LLC plays a role in meeting this requirement. Clarifying whether the LLC is treated as a disregarded entity or separate taxable entity is crucial to ensuring compliance with this rule and avoiding complications in the exchange process.

At times, further inquiry needs to be conducted by the member(s) or their advisory team to confirm the type of entity. The Operating Agreement created at the time the LLC was formed will provide this distinction. The Operating Agreement contains many provisions including identifying the member(s) and verifying the relative ownership interests among the members, among others. Usually, the Operating Agreement is created when the LLC is formed with the assistance of an attorney or other professional service.

However, when investors form LLCs online without professional assistance, or when they reside in states that do not require an Operating Agreement, they may not exist. In the absence of an Operating Agreement, it is best to determine whether the LLC files its own income tax returns or reflects the ownership of the real estate on the member's personal income tax return. Due to the Same Taxpayer Rule, maintaining the tax continuity of the Exchanger is required, it is necessary to structure the 1031 Exchange consistent with the way the LLC has been filing annual tax returns. If it can be confirmed that the LLC is being treated as a disregarded entity, then the 1031 Exchange can be structured by reflecting the member as the Taxpayer.

When the Relinquished Property is owned in a Single-Member LLC, a disregarded entity, it gives the Exchanger some additional flexibility in the acquisition of the Replacement Property(ies). This is ideal because many investors often prefer to acquire new properties in a new Single-Member LLC to enjoy the protections afforded by the LLC structure noted above, including liabilities and debts being isolated within the LLC. So long as the same member is the member of the new SMLLC, they are in compliance with the Same Taxpayer Rule. Additionally, a surface level advantage of a SMLLC is that investors often like to name their LLCs to correspond with the property that it owns, i.e., '1313 Mockingbird Lane LLC.' Naturally, the investor would not want to acquire 1428 Elm Street in the name of 1313 Mockingbird Lane LLC. Since 1313 Mockingbird Lane LLC is a disregarded entity, the investor can acquire the Replacement Property under 1428 Elm Street LLC without jeopardizing the 1031 Exchange. The important thing to note is that owning both the Relinquished and Replacement Properties in a SMLLC provides for ongoing protections afforded by the LLC structure.

As noted above, a Multi-Member LLC is a tax partnership, and its own unique Taxpayer. When a Multi-Member LLC owns the property, the 1031 Exchange is to be set up under the name of the LLC. For example, when the members of 4 Privet Drive LLC want to sell their current investment property, their options for purchasing Replacement Property are somewhat limited because of the Same Taxpayer Rule. They could acquire the Replacement Property in the name of 4 Privet Drive LLC, which wouldn't make much sense if they are acquiring 1630 Revello Drive. In addition, using the old LLC to hold the new property might make the new LLC liable for claims that may come up in regard to the old property ownership. However, because they wish to maintain the protections of the LLC structure, while also changing the way the new property is held, a new LLC, 1630 Revello Drive LLC, could be created to take title in that name, if 4 Privet Drive LLC is the sole member of the new entity.

1031 Exchange Involving Multi-Member LLCs

Sometimes when property is held within a Multi-Member LLC not all members have the same opinion of what they want to do with their portion of the sale proceeds. One possibility is where all members of the LLC want to go their separate ways, each doing their own 1031 Exchange. That results in what would be called a "drop and swap", where all members drop their LLC interest to a Tenants-In-Common interest and complete their own 1031 Exchanges. Much has been written about the drop and swap strategy, and its relative merits in the 1031 Exchange context.

However, if multiple members are willing to stay inside the LLC, even though one party wishes to leave, there are other options. Consider a three-member LLC, where each member owns 1/3 of the membership interests, but one member wishes to leave. In this situation, Three Friends LLC could allow one member to leave in exchange for a 1/3 Tenant-in-Common interest in the real estate, while the other two members remain inside Three Friends LLC. At closing, the departing member takes their respective share of the proceeds while Three Friends LLC continues and completes its 1031 Exchange with 2/3 of the proceeds. Note that this is a simplified statement of how the structure changes, and investors considering this should consult with their tax and legal advisors prior to initiating an exchange.

Adding members to the LLC also has multiple possible outcomes. If the LLC is already a partnership, then admitting additional members does not change anything for 1031 Exchange purposes. There are accounting issues that the accountant would normally address. However, if the LLC was a single-member LLC, which is being treated as a disregarded entity, then adding a new member creates a partnership, which cannot be a disregarded entity. This situation often arises when one spouse has premarital investment property, and they are now wanting to structure a 1031 Exchange and add their spouse as a partner on the Replacement Property. For example, when Gomez was single, he bought his current investment property and the title is vested in Addams Realty Holdings LLC, of which he is the sole member. Now that he is contemplating a 1031 Exchange, Morticia wants to be a member of the LLC so that she has ownership interests in the Replacement Property. This should not be done, as it would convert the disregarded entity into a partnership, creating a new Taxpayer. It should be possible to change to a partnership when some time has passed from the exchange transaction. It is best to consult with the tax adviser to determine the appropriate amount of time.

Community Property States

Community property laws dictate how property is owned and managed between spouses in certain states. These laws establish that all assets acquired during the marriage are considered jointly owned by both spouses, regardless of whose name is on title. Community property states include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. These laws impact 1031 Exchanges for LLCs owned by married couples who live in those states. According to IRS Revenue Procedure 2002-69, if the LLC is properly formed, its only members are a married couple who reside in a community property state, and the couple elected to treat the LLC as a disregarded entity for federal tax purposes, the IRS will recognize it as disregarded. This allows flexibility for spouses residing in a Community Property state who are involved in a 1031 Exchange. to treat the LLC as a disregarded entity for federal tax purposes, the IRS will recognize it as disregarded. This allows flexibility for spouses residing in a Community Property state who are involved in a 1031 Exchange.

In looking at the example above, if Gomez and Morticia live in a community property state, Gomez could add Morticia as a member of Addams Realty Holdings LLC without jeopardizing the LLC's status as a disregarded entity. This means their 1031 Exchange could proceed with the same LLC even though Morticia will be added as a member of the LLC.

As discussed, owning investment real estate in an LLC can add an additional layer of complexity when a 1031 Exchange is being considered. When structuring a 1031 Exchange involving real estate vested in an LLC or being bought in the name of an LLC, additional care must be taken to ensure compliance with the 1031 Exchange rules. Exchangers are encouraged to consult with their tax and legal advisors before the move forward with the sale or purchase of investment real estate, and to engage a Qualified Intermediary before the first closing that will be part of their 1031 Exchange.