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## A L A W C O R P O R A T I O N

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### **Should My Rentals be in an LLC?**

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If you own real property – especially residential rental property – you’ve probably given some thought to liability protection. You’ve probably also considered placing properties in a limited liability company (LLC) as a means of liability protection. This makes sense; an LLC does provide you and your personal assets a layer of protection against liabilities and claims that may be made against the LLC. However, an LLC is not necessarily the right choice for every situation – and, in fact, an LLC may add significant expense and may even cause forfeiture of valuable tax benefits.

For most residential properties, there is relatively little risk of liability. As a residential landlord, your risks are most likely associated with slip and fall injuries or security issues, such as property break-ins.

But these instances are usually covered by insurance. In that case, the liability protection benefits of an LLC are realized only if the damages are so high that they exceed all insurance coverage. Therefore, in many cases, spending more on umbrella insurance coverage, instead of an LLC, could be wise. Umbrella insurance coverage provides additional dollars of coverage over the insurance policy for a very modest cost. Consider that the cost of simply maintaining an LLC in California is typically around \$1,000 per year – which includes the \$800 minimum annual franchise tax, as well as other regular filing fees (you may also incur additional CPA and attorney fees). You may be better off taking that more than \$1,000 and buying a good umbrella insurance policy. This opportunity is worth calling your insurance broker to explain.

Furthermore, if your LLC is taxed as anything other than a partnership or disregarded entity (for example, if the LLC has elected S Corporation tax treatment), your heirs may lose the benefits of a stepped-up income tax basis in the property at your death.<sup>1</sup> That is, at your death, all property held in your name receives a step-up in income tax basis, such that the basis for income tax purposes is “stepped-up” and equal to the value of the property as of the date of

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<sup>1</sup> NOTE TO DRAFT: If the LLC is taxed as a partnership, then the heirs can make a 754 election to preserve the step-up in basis as to the property. A 754 election allows for the outside basis to match the inside basis.

death. Therefore, if your heirs were to sell your property immediately after your death, your heirs would experience no taxable gain and thus would not have to pay any taxes on the sale. However, if the property is owned by the LLC that is not taxed as a partnership, then the step-up in basis may apply only to the LLC interests, and not to the property itself. In that case, your heirs would have to sell the LLC – and not just the property – to avoid a taxable gain (for various reasons, this is a much smaller and tougher market to navigate). If the property were to be sold without a step-up in basis, your heirs may have to pay taxes based on the gain in proportion to your original basis in the property – depending on how long you've held the property and how much it has appreciated over time, this could be a significant tax expense. Therefore, before holding property in an LLC, it's important to first determine the manner in which the LLC will be treated for tax purposes and consider implication of that treatment on future taxes.

In sum, before placing property in an LLC, you must consider why you are doing so: if it is to minimize taxes, based on advice from a CPA, that may be a good move. On the other hand, if it is solely to minimize liability, it may not be worth doing – and may have unintended tax consequences down the road.

We are glad to discuss all these issues, and your personal considerations. Please contact us to set a time to do so.