Purchasing LLC Membership Interests vs. Real Estate: Pros and Cons

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When a real estate transaction closes in Wisconsin there is a transfer fee that must be paid to the State of Wisconsin which is equal to 0.3% of the purchase price. Additionally, the sale price is factored into the assessed value of the real estate. Unfortunately, this often means that after purchasing real estate, the property taxes owed for the following tax year will be more than in the year the property was purchased.

One way to avoid these additional costs is to purchase all of the membership interests of the limited liability company (LLC) that holds the real estate. This allows real estate purchasers to take title to the real estate without changing the legal owner of the real estate. Since title to the real estate remains with the existing owner-entity, there is no change in ownership even though there is a change in control of the real estate. Despite past efforts of the legislature to the contrary, changes in control of real estate do not trigger property tax re-assessments, however changes in ownership of real estate do trigger such consequences. For example, if a developer purchases a building with an assessed value of $2,000,000.00 for $4,000,000.00, the developer can save $12,000 on the transfer fee and, hopefully defer property tax re-assessment, which could mean thousands more in savings. The potential savings are even higher on redevelopment or owner-occupant purchases where the buyer brings a new tenant that will cause the value of the property to increase.

While purchasing the membership interests of an LLC can have significant monetary benefits, there are some downside risks that must be evaluated. The first risk, and quite likely the largest risk, is that the purchase of membership interests of an LLC includes any and all liabilities of the LLC, whether the LLC knows about them or not. This means that a purchaser of an LLC's membership interests must do significant due diligence on the LLC, in addition to the typical real estate due diligence. The most important aspect of due diligence is confirming whether the LLC has or ever had employees, the status of those employees, and whether the LLC paid all necessary employment and other taxes related to the employees.

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Another significant issue is that the deal may not be able to get done because there are too many people at the negotiating table. If the acquired LLC is a multi-member LLC, then purchasing the membership interests may bring in each of the members and their respective opinions on price, terms and other sale aspects. Often in a multi-member LLC, there is a single manager that can make decisions regarding the sale of assets. The problem is further exacerbated if not all of the LLC's members are bought out. This one point of contact often makes it easier to get a deal done than working with two or more counterparties.

Purchasing the membership interests in an LLC may also make obtaining financing more difficult. Often lenders prefer to finance the acquisition of title to real estate, not the membership interests in the real estate title holder because it is a cleaner transaction with less risk of undisclosed liabilities impacting the lender or its borrower. To offset this additional risk, purchasers of LLC membership interests should expect their lenders to require additional covenants and such purchasers should obtain pre-approval from their lender before entering into an agreement to purchase the membership interests of an LLC.

Finally, it should be noted that the transaction costs for purchasing the membership interests in an LLC will often have higher transaction costs. Since purchasers of LLC membership interests are purchasing both the assets and the liabilities of the acquired LLC, it is important for the purchaser to conduct adequate due diligence to minimize the risk of any undisclosed liabilities causing damage to the purchaser. Such due diligence includes the typical title insurance policy and lien searches of the seller and the property, but should also include a number of additional representations and warranties of the seller confirming there are no undisclosed liabilities.

The practical aspects of closing on the sale of membership interests also have several nuances. When closing on the sale of an LLC's membership interests, new title, or at least a date-down endorsement should be obtained to ensure that title to the underlying real estate is acceptable to the buyer. A title company can also be used to close the transaction and facilitate the disbursement of funds. All monetary liens on the property should be paid and released at closing, unless the loan is being assumed. It is also important to obtain an indemnity for any unknown liabilities that may arise after closing. In conjunction with this indemnity, it is often desirable for the seller to put a portion of the sale proceeds into an escrow to ensure that there are funds available to pay any indemnification liabilities that may arise.

Purchasing the membership interests of a real estate owning limited liability company can present additional risk compared to purchasing the underlying real estate, but done in a careful manner, it can provide economic benefits that may greatly increase the economic feasibility of the proposed project.