

Entity Primer

If you are reading this you are probably one of the many people who are dipping their toe into real estate investing. If this is the case, asset protection for your property is critical to the long term success of your real estate journey and protecting your wealth.

Understanding asset protection and hiring an asset protection attorney should be one of your first steps.

One of the hardest assets to protect is real estate. You can't move it ...you can't hide it ...what else can you do?

When using institutional lenders, real estate is something you borrow with money under your name ...the land is put under your name ... the loan is put in your name ... everything has your name around it. So how can you possibly keep real estate safe?

Owning property in your own name means that in the event you are sued and found guilty ...anything your insurance policy does not cover will come out of your own pocket. Putting an entity between you and this personal liability means that your personal assets will stay protected. It is what will protect you from the risk of tenant injuries, trespassers, unauthorized dumping, or storing of hazardous waste. Putting an entity between you and the property means you don't own the property, your entity owns the property.

While we are talking about asset protection, this protection does not take the place of having full comprehensive property insurance coverage. In the event of a lawsuit brought against the entity, comprehensive insurance can save you money in the long run. If the entity had no insurance coverage in place, a court may order the property sold to pay the judgment. However, if a lawsuit is brought against you personally, and a claimant attempts to seize assets you hold through an entity, the rules are a different.

As stated above, a dilemma you will come across is that the majority of lenders will not allow you to put your asset protection strategies in place at closing...but force you to close and hold title in your personal name. This process denies you of protection against tenant and vendor claims placing your personal assets at risk. If after closing

you desire to place the property in an entity, the bank could call the "due on sale" clause in your mortgage contract. There are loan companies who will lend to entities but do your homework as some of them have higher interest rates.

What is the best business entity to use for real-estate investments? There are many questions that you should ask an attorney when choosing an entity. Here are a few of them:

- ◆ What entity has excellent liability protection for managers and members?
- ◆ What entity has flow-through tax treatment on profits and losses?
- ◆ What entity allows you the ability to transfer properties in and out with minimal tax consequences?
- ◆ What entity gives you the most protection in case of a Charging Order or Lien?

Your attorney will most likely suggest two different entities. Limited Liability Company (LLC) or a Limited Partnership (LP).

Limited Liability Company (LLC) – a hybrid type of legal entity that combines certain traits of corporations with certain other traits of partnerships and other non-corporate legal entities. LLC's allow their owners (called members) to have the best of all worlds: pass-through tax treatment like a partnership, limited liability like a corporation, unheralded flexibility in ownership and management structure, and charging order protection.

LLC's origins date back to 1892 in Germany. Once established in Germany, the concept of the LLC had a very active and fast growth. Within a short period of time after enactment in Germany, the following countries joined the limited liability bandwagon: Portugal (1917); Brazil (1919); Chile (1923); France (1925); Turkey (1926); Cuba (1929); Argentina (1932); Uruguay (1933); Mexico (1934); Belgium (1935); Switzerland (1936); Italy (1936); Peru (1936); Columbia (1937); Costa Rica (1942); Guatemala (1942); and Honduras (1950).

In 1977, Wyoming became the first

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American state to enact a true LLC act modeled after the original 1892 German LLC. The Wyoming LLC Act permitted the formation of LLC's organized for any lawful purpose except the business of banking and insurance.

In your operating agreement for the LLC you will designate if you want the LLC to be member or manager managed. We cover the detail of each in the Operating Agreement article.

- ◆ **Member-Managed LLC (MgrLLC)** – An LLC that allows the members to have management rights, very similar in operation to a general partnership, but with some degree of limited liability for the members. With a Member Managed LLC, the members are in a role very similar to limited partners.
- ◆ **Manager-Managed LLC (MemLLC)** – An LLC that provides for one or more designated managers to have management rights, and with the members having no management rights.
- ◆ **Single-Member LLC (SMLLC)** – An LLC with but one member, who is typically also the manager, formed in a jurisdiction that allows a single member. Because they are relatively untested, the liability protections of SMLLCs are mostly theoretical, but should be similar to that of a sole-shareholder corporation. Not recommended for real estate.

Charging order works in the same fashion as a lien -- it is an obligation to pay money placed over the real estate. When a judgment is placed on your property it does not give the person voting rights, any ability to control the decisions or the ability to force profit distributions. The charging order merely grants the creditor the right to receive a portion of the profits until the judgment is completely paid. And, in a fairly ironic twist, the monies received by a judgment creditor through a charging order is treated as income and taxed.

Each state has its own charging order laws. Nevada seems to be one of the strongest, if not the strongest. One way to get around that is to talk with your attorney about forming an LLC in the state where the property is located and a second one, a passive holding one in Nevada. This

passive holding LLC will hold all the interests of the first LLC. What will happen in the event of a lawsuit brought against you personally is that no matter in what state a lawsuit is brought, a creditor will eventually have to come to Nevada to attempt to seize the assets, and will then run up against the charging order procedure. It costs a little more to set up and maintain, but if you are truly trying to make yourself as small a target as possible, it is a fairly cost-effective solution.

This brings up having multiple properties in one LLC. The question you need to ask yourself is how risk tolerant are you? If you have several properties held in an LLC and you depend on the income stream, then a charging order placed against that LLC could cause a major disruption to your earnings. If you are investing in single family homes, it might not make sense to have each home in a separate LLC, but you will have determine for yourself how many properties to hold in a given LLC. In commercial properties typically investors have each property in its own entity.

Limited Partnerships (LP) - are a much older entity than LLC's, and the law over how the Limited Partnership is controlled is much more settled. The earliest limited partnership arose in Rome in the third century B.C. During the heyday of the Roman Empire they were roughly equivalent to today's major corporations. In the US, limited partnerships became widely available in the early 1800s.

If the state you're doing business in assesses an additional franchise tax fee with earnings over a specific amount, or if you have very high income-earning properties, you could wind up paying extra taxes if your property is held in an LLC. To avoid that, investors sometimes use a Limited Partnership, as it does not have the extra franchise fee levied on its earnings. However, if you operate your Limited Partnership with a corporate General Partner, then you have the filing and operating costs for two entities in some states, rather than one, not to mention two franchise tax fees. Talk with your attorney about the income of the property so they

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have all the facts when they consult about the appropriate entity.

Inform your attorney if you are going to be using the entity for estate planning purposes to pass your wealth through to the next generation. Perhaps you foresee trouble on the horizon with your children wanting control once they have gained a majority interest. In a Limited Partnership, a General Partner cannot be removed in most instances unless they are found guilty of serious misdoing or defrauding the LP. With an LLC you might draft your operating agreement as strongly as possible to give you control over daily operations, even after you have transferred majority interest in the LLC to your children. There is still a chance that the kids will be able to make a good legal argument in front of a sympathetic judge and have the operating agreement set aside.

At this point in time we will cover quickly S or C Corporations as they are not recommended to hold real estate. Each receives its name from the IRS code. LLC's have an extra advantage over an S-corp (or a C-corp) where you want to convert a property to personal use, or trade it (called a "like-kind exchange" and subject to special rules) for another home of similar value. If held in an S-corp the conversion or trade of property would be considered a sale with the accompanying tax consequences. Held in an LLC, there are no tax consequences to converting or trading the property.

A C Corporation is taxed at two levels. First...pays corporation taxes on corporate profits. Then, with any money left over, the corporation may distribute profits to the shareholders who are again taxed. Thus, the imposition of "double taxation". Despite the double taxation, C Corporations offer many planning and tax benefit opportunities. This may be the entity type to use for a property management company.

An S Corporation is taxed as a flow through entity (similar to a LLC or LP). The S election allows the shareholders to be taxed only at the

individual level instead of at both the corporate and individual level, thus avoiding the double taxation like the C corporation. The S corporation still provides limited liability protection and is a good entity for many business situations.

Once you have chosen the entity type...there are many other decisions and steps that you need to be aware of:

1. The first is corporate formalities, which must be met in order to maintain the limited liability protection that the entities give you. These include filing statement, paying annual fees, maintaining a resident agent, and keeping corporate minutes. If you fail to follow the formalities you, your officer, directors and shareholders can be personally liable and the entity "penetrated."
 - a. Above we mentioned maintaining a resident agent. Each state requires that a resident (or registered) agent be identified and located in the state of incorporation and any states where business is conducted. Their job is to accept service of process (i.e., notice of a lawsuit) and other official notices. Because lawsuits are served on the resident agent it is important to use a service that appreciates the importance of such notices and has been in business for a long time. You want them to have experience and continue to be in the business for a long time. Be sure to sign a statement giving consent of appointment to the registered agent.
 - b. Corporate Minutes - Most every state requires that the owners and managers of an entity meet once a year to discuss the affairs of the business. To prove that this required meeting took place, minutes detailing only decisions made at the meeting are written and kept with the corporate, LLC or LP records. For a fee you can have this done for you, but keep in mind that this is only detailing decisions, so it doesn't have to be a cumbersome document. Travel to the meeting may be tax deductible.
2. The next is an Employer Identification Number (EIN). This is like a Social Security Number for a business. The IRS assigns such a number to each newly formed entity. It is used as an identifier when opening bank accounts, hiring employees and the like. The

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attorney setting up your entity will apply for the EIN for you.

3. Corporate Notice - is where you provide the public with notice that you are doing business as a corporation. To that end, you will use Inc., LLC or LP, for example, on all of your brochures, contracts, checks, cards, and the like.
4. Entity Name - you cannot use the name of a corporation, LLC or LP that is already in use and registered with the state and if you are going to organize in one state and qualify in another the name must be available for use in both states. When you are deciding on an entity, have several name in mind. It will make it easier not to have to go back and forth with your attorney should your first or second choice be already taken.

Talk over timing with your attorney. You will need to know how many days it takes to set up an entity and if you are going to be doing business in another state there could be some additional time delays. It is important to talk about timing as you don't want to put the money out for an entity until you need to, but you will want the protection when you sign closing papers.

As a member of The Wealthy Daughter we are always willing to open up our rolodex to you. [Email](#) us and we will share with you who we partner with in selecting the appropriate corporate structures to limit our liability, protect our assets, advance our personal and financial goals through real estate investments and other means of wealth creation.

This article is meant to start you on your educational journey in regards to entities It is not to take the place of talking with an attorney. It is not to be construed as legal advice. Legal information is not the same as legal advice -- the application of law to an individual's specific circumstances. Although we go to great lengths to make sure our information is accurate and useful, we highly recommend you consult a lawyer for advice appropriate to your particular situation.