

LLCs and Liability Protection

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An affordable and very effective method to shield your assets from attack is to transfer your rental property to a Limited Liability Company (LLC). Holding title to investment property through an LLC limits the liabilities of the business to only those assets held within the LLC. In the same way as shareholders of a corporation are shielded from liability, a properly formed LLC will guard its owners from lawsuit liability, including liability from acts of its employees and agents.

There are several significant benefits the California LLC can provide to you or your investors. The LLC creates a risk barrier which encourages apartment ownership, yet shields the owner's personal assets from lawsuits and seizure. The double taxation and extensive formalities inherent with traditional corporations are eliminated. When legal action such as an eviction is required against a tenant, it is the LLC, rather than the individual owner, that pursues the claim. In addition, the landlord's privacy is enhanced because rent checks are made payable to the LLC, lease agreements are between the LLC and the tenant, and correspondence comes from the LLC.

While high limit liability insurance is important, it is still not adequate to protect the property owner(s) from loss of assets. Most insurance policies contain exclusions for mold, lead-based paint and other environmental hazards. Additionally, they rarely cover judgments arising out of discrimination claims. Even with expensive high-limit insurance coverage, a major incident such as a fire or balcony collapse resulting in numerous claims, could create liability far exceeding your policy limit. Even with the best of intentions regarding your tenants, the LLC has become a necessary tool in limiting liability not only for legitimate claims, but also for those in which only a brainwashed jury could see merit. The deductible \$800 annual State franchise tax on LLCs is small compared to the huge benefit provided.

In recent years, the State of Nevada LLC has been touted as an asset protection alternative to the California LLC, since the annual tax is relatively small compared to California. However, in most cases there is little or no financial benefit to forming a Nevada LLC for your California rental property, because the ownership of the California property necessarily means business is transacted in California. As such, the Nevada LLC also must be registered with the California Secretary of State and pay the initial California registration fee and \$800 annual franchise tax, along with California income tax. (Ca. Rev & Tax Code Sec. 17941, Ca. Corp. Code Sec. 17050). For business ventures other than California real estate, where the principal business is not transacted in California, the Nevada LLC/Corporation may be an attractive option for investors.

Additional benefits of the LLC include the ability of LLCs to utilize 1031 exchanges and exemption from the 3 1/3 withholding on sale of real estate for multi-member LLCs. Furthermore, a separate federal tax return is usually not required for single-member LLCs, including those owned by a husband-wife or living trust, and the property transfer to the LLC is almost always exempt from tax reassessment. And the LLC will work very

well in conjunction with a living trust to simultaneously protect and preserve estate assets.

Many apartment owners have executed a living trust in order to provide for the distribution of their assets after they die, as well as to avoid huge probate costs, reduce or eliminate estate taxes when they die, and prevent court control of their assets should they become incapacitated. The living trust, however, will not protect against lawsuits. If an apartment building is held directly by a living trust, then all other assets in the trust will be exposed to lawsuit liabilities generated by the building. A much better approach is to place your apartment in an LLC, creating a liability barrier in order to protect all of the other trust assets. The LLC membership interests may then be safely added to the trust.

As far as multiple investments are concerned, it is better to have a separate LLC for each rental property so that liability arising from one property cannot attach to any other properties. Even single-family homes with tenants should be held by their own LLC. If paying \$800 annually each for multiple LLCs is not a viable option, then properties could be grouped together. Owning a total of six investment properties with three in one LLC and three in the other would afford significantly more protection than owning all the properties in one's personal name. For those investors wishing to transfer multiple properties with annual gross rental receipts totaling more than \$500,000 into a single entity, the use of a limited partnership should be considered. Both the limited partnership and the LLC must pay the \$800 franchise tax, but the LLC must pay an additional gross receipts tax if the gross annual receipts exceed \$250,000.

Because landlords are subject to virtually unlimited lawsuit exposure and financial liability arising out of ownership of their rental property, they must take advantage of every lawful means to protect their assets. Once a competent attorney prepares and files the array of legal documents required for the initial formation of the LLC, personal assets will no longer be reachable to satisfy any debts or judgments against the LLC.

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