

**Asset Protection and Growth for Landlords
Why You Should Have an LLC
by David Stelzer, Esq.**

It's no longer new news that a Limited Liability Company (LLC) is a popular vehicle for landlord's to own real estate in California. What you may not know however is why it is to your benefit. The answer is two fold. First, an LLC can shield you and your personal assets against litigation, and second, an LLC can help you grow your business as a landlord, while keeping more of the money you earn through valuable tax savings.

If you own your buildings as an individual or sole proprietor, you are a target for a lawsuit!!!!

Are You a Target For A Lawsuit?

You may have heard that if you own your property as an individual or sole proprietor (such as a DBA), you are exposed, but what does that really mean? Let's put it into perspective. To start off, nine out of every ten lawsuits filed in the world are filed in the United States. A new lawsuit is filed every thirty seconds! Based on this fact, it has been shown that if you are a business owner, you have a one in three chance of being named as a defendant in a lawsuit in the next year; as a landlord, your properties are looked at as a business. To make matters worse, there are currently about 700,000 lawyers in this country with another 100,000 in law school at any given time.

Many of these lawyers make their money from taking contingent fee cases; cases that they only make money on if they get money for their clients. Many contingent fee cases happen for reasons such as negligence or injury claims, whether justified or not, breach of contract through no fault of your own, or lawsuits from disgruntled employees or tenants. As an individual in these cases, you are personally liable, and you will have to defend yourself. If you are fortunate enough to have insurance, yet a judgment exceeds that insurance coverage, you would be personally liable for that additional amount. If you do not have the cash on hand, the plaintiff can go after your personal property, your real property and any other asset they can locate. Additionally, the judgment can follow you around for the rest of your life, since it can be renewed every ten years, while earning interest at the rate of 10% per year. Can you afford to take that kind of risk?

Use of the LLC for Ownership of Investment Real Estate

Instead of owning your rental property in your own name, you can form a business entity to own it in whole or in part. The limited liability company (LLC) is like a sole proprietorship or partnership in that its owners (called members) jointly own and manage the business and share in the profits. However, an LLC is also like a corporation because its owners must file papers with the state to create the LLC and it exists as a separate legal entity. Once these papers are filed with the state, your attorney will create a document called the Operating Agreement, which states the rules for running your LLC, and transfer your properties into the LLC, and you are off and running. An experienced attorney can do this for you in about 2 weeks, and you should not expect to pay more than \$1500.00 for a standard LLC.

Unlike the exposure to an individual, as illustrated above, an LLC provides its members with protection from personal liability to all members, including member/managers and managers that are not members, like a corporation, while also having certain distinct tax advantages, which will be discussed below.

Additionally, unlike in the scenarios above, creditors of members of an LLC (including successful plaintiffs), like creditors of partners in a partnership cannot get at the assets of the LLC, and cannot step into the shoes of the member. Even a creditor who has a judgment against a member is restricted by law from taking over the membership interest in a manner that would give the creditor the same powers that the member has. Although under current law a creditor

can foreclose on the interest of a member, the LLC law and operating agreement usually establish obstacles that limit the creditor to receiving only the distributions that that LLC member would be entitled to (if any), rather than real membership. A creditor who has a judgment against a member of an LLC cannot take over the LLC interest of the member even after foreclosure unless the operating agreement or a majority of the other members allows the creditor to do so, while the foreclosing creditor of a shareholder of a corporation can become a shareholder of the corporation. The law also makes it much more difficult to collect on judgments directly against an LLC, not to mention that the LLC can hold very little cash or assets, by passing them along to their owners, or by encumbering them.

The LLC is also more beneficial to the small business owner, because it requires fewer formalities to maintain. A corporation requires quarterly meetings, with minimum amounts of the board in attendance. A corporation requires that detailed records be kept such as corporate minutes, and for action to happen, written corporate resolutions must be recorded. An LLC merely requires the initial filing with the State of Articles of Organization, and then the drafting of an Operating Agreement, stating the rules of the business. From there, you keep separate accounts and business records, and you are not required to keep written resolutions, minutes or other formalities.

Tax Treatments and Benefits of the LLC

For tax purposes, the LLC is what is called a "pass-through" entity. A pass-through entity does not pay any taxes for the entity itself. Instead, the business's profits or losses are passed through to its owners, who include them on their own personal tax returns (IRS Form 1040). If and when a profit is passed through to the owner, the owner must add that money to any income from other sources, and pay tax on the total amount. If a loss is passed through to the owner, he or she can deduct it from other income, subject to the restrictions on deducting rental losses, as permitted by California and the IRS. Because pass-through taxation permits property owners to deduct losses from their personal taxes, it is considered the best form of taxation for real estate ownership. The pass through provision in regards to profits is only applicable to profits actually passed down to the members, so if the LLC pays much of your expenses, then there is less to pass through and create a tax basis (this will be more fully discussed below).

Again, the above tax structure is also what is referred to as single taxation, because you are not paying tax on the business entity, and on personal income taxes [1]. A standard corporation has what is called double taxation, where the corporation must file a tax return and pay taxes, and its shareholders must also file taxes.

Although pass-through entities don't pay taxes, their income and expenses must still be reported to the IRS as follows: LLCs with only one member are treated like a sole proprietorship for tax purposes (not to be confused with your liability protection). The member reports profits, losses, and deductions on Schedule C of their personal tax returns, Profit or Loss from a Business. An LLC with two or more members is treated like a partnership for tax purposes, except in the unusual situation where the owners choose to have it treated like a C or S corporation.

Landlords who own their properties through an LLC don't use individual Schedule Es to report their rental income or losses. Instead, the LLC files IRS Form 8825, Rental Real Estate Income and Expenses of a Partnership or an S Corporation to report the income and deductions from the property owned by the entity. This form is very similar to Schedule E.

The only downside, in terms of LLC taxation, is what is called the Gross Receipts Tax. This is a tax that does not add additional tax liability to the LLC until the Gross Receipts for any tax year are greater than \$250,000. In most cases, real estate investors for rental purposes are able to avoid this additional tax, but in some cases where they own large amounts of property, or their LLC does more than hold real estate and collect modest rents, an owner of the LLC would be subject to this additional tax. The Gross Receipts Tax is as follows:

GROSS RECEIPTS	TAX
\$250,000 to \$499,999	\$900

\$500,000 to \$999,999	\$2,500
\$1,000,000 to \$4,999,999	\$6,000
\$5,000,000 and over	\$11,790

The above chart is reflective of taxes payable to the Franchise Tax Board. As discussed above, any federal taxes are dealt with through the member's personal tax returns, and their respective schedules. As you can also see from the above chart, the state business taxes are relatively low, and the more that your LLC pays for, in terms of business expenses, the less of a tax basis the member will have for their personal income taxes.

In addition to the tax protection of an LLC, you may also want to consider a Revocable Living Trust in conjunction with your LLC. A Revocable living trust will help you protect assets that might be subject to probate, and are very helpful when family members only property together. For more information on Revocable living trusts, you can read this helpful article from the California State Bar at http://calbar.ca.gov/state/calbar/calbar_generic.jsp?cid=10581&id=2212.

Reducing Your Tax Liability Using Your LLC to Pay Your Expenses

One of the great characteristics of owning a business entity, which you don't get to do as a sole proprietor, is having your business pay your expenses, while lowering your tax basis. Remember, you don't pay federal tax for your LLC. You pay a state tax based on Gross Receipts, and the rest goes on your personal federal return, by way of what profits or losses pass through to you from your company. Obviously, the more expenses your LLC has to pay, the less money will be available to pass through to you, thereby lowering your taxable income.

As an example, let's say that your building brings in \$150,000 a year in gross receipts, and for ease of this example, let's say that this is the only business that your LLC does; collecting rents from this one building. Because the gross receipts are less than \$250,000, you will only pay the yearly \$800 tax to the Franchise Tax Board. The only additional tax to pay would be your personal federal and state taxes. Without your business having any expenses, you would take a \$150,000 hit on your taxes as personal income, but if you have business expenses, this can be reduced.

You would be surprised at how much can be claimed from your business to reduce your personal tax liability. Your business can have expenses for your cellular phone, the gas in your car, your mileage from point to point, the lease of a vehicle, maintenance, gardening etc. At the end of the day, if the value of these expenses comes out to an amount equal or greater than the amount you have taken in, you have reduced your personal tax liability to zero!

The list of deductions permitted for an LLC include, but are not limited to, advertising, bad debts, mileage (which as of Dec. of 2005 was 48.5 cents per mile), commissions and fees, depreciation of assets, organizational dues, health insurance, insurance, interest, legal and professional fees, office expenses, rents or leases, supplies, taxes and licenses, pension and profit sharing costs, travel (if related to your core business), meals and entertainment (if related to your core business), utilities and employee wages.

If you normal pay any of these expenses personally, you can now shift them to the LLC. In addition, because you are now a business, you may be entitled to certain benefits, such as business banking, better loan rates, group insurance rates, fleet car discounts, etc. All of the expenses that were once personal should now be put in the LLC, and have the LLC directly pay those expenses. Once all the expenses are paid, then you can decide to take cash distributions from the LLC. Or, you can leave the cash in the LLC, and prior to year end, find a use for it so that it does not end up as a profit.

In some cases, people even decide to make themselves employees of the LLC. By doing this, they can pay themselves small salaries and be entitled to employee benefits, such as medical insurance and profit sharing plans. The cost of administering these plans, such as the fees and taxes, are deductible by the LLC. Since the employee is taking a very small salary, their personal tax is minimal, while they help to reduce the overall tax basis of the LLC.

Overall, you can see that the LLC is an effective means of protection, and wealth preservation for the landlord. The LLC will shield its owners from personal liability that may occur from their tenants, it will help reduce their tax burden, and can bring many financial benefits. An

LLC combined with a solid estate plan, or asset protection plan is a must have for any property owner.

[1] It is important to note that at the formation of the LLC, and on a yearly basis thereafter, a minimum tax of \$800 per year is payable to the Franchise Tax Board for operating this type of entity in California. Additional taxes, for California and not the IRS apply based on the gross receipts generated by the LLC.

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