

How Landlords Can Protect Their Assets

by Michael K. Elson, Attorney at Law

As a landlord you are subject to virtually unlimited financial liability and exposure arising out of the ownership and operation of your rental property, so you must take advantage of every lawful means to protect your assets. Though you may have the best of intentions regarding your tenants, you can still be successfully sued and placed in serious financial jeopardy, potentially leaving you bankrupt. Landlords have become fertile grounds for lawsuits because they possess valuable business and personal assets, which can be seized to satisfy a judgment.

Liability can arise from numerous sources including tenant applicants, managers, tenants, guests, vendors, contractors, dog bites, slip and falls, and other premises liability. As a result of high profile lawsuits and large damage awards topping \$20 million, many insurers have sharply increased their rates, while reducing or eliminating certain coverage in their policies, including mold, lead based paint, asbestos, discrimination, and harassment. Even with expensive umbrella policies, a crippling injury, homicide, rape, or a fire or balcony collapse resulting in numerous claims, can create liability far exceeding your policy limit.

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, and nothing else. 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. Consequently, the business owners' residence, bank accounts, vehicles and other investments are insulated from lawsuits.

Like a corporation, an LLC is a separate and distinct business entity requiring its own bank account and taxpayer identification number. However, the LLC is generally more attractive to property investors than the traditional corporation, because there is no double taxation and there are fewer formalities. Once the LLC becomes the legal title holder of the property, 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. When evictions are necessary, the LLC, rather than the individual owner, pursues the claim against the tenant.

LLCs are favored by investors because they create a risk barrier which encourages apartment ownership, yet shields the owner's personal assets from lawsuits and seizure. Other beneficial attributes include:

- The ability of LLCs to utilize 1031 exchanges
- Exemption from the 3 1/3 withholding on sale of real estate for multi-member LLCs
- A federal tax return is typically not required for single-member LLCs, including those owned by a husband-wife or living trust
- The deductible \$800 annual state franchise tax on LLCs is small compared to the huge benefit provided
- The property transfer to the LLC is exempt from tax reassessment provided the critical paperwork is executed correctly

Interestingly, many of my clients have inquired about Nevada LLCs since the annual tax is relatively small. 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 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.

While the LLC can be utilized to effectively *protect* your personal assets from lawsuits, a Living Trust can effectively *preserve* your assets by avoiding huge probate costs and reducing or potentially eliminating estate taxes when you die, and preventing court control of your assets if you become incapacitated. The Living Trust is a legal instrument that holds title to a person's personal assets, including bank accounts, real estate, stocks, LLC membership interests, etc. The Living Trust contains your instructions for the distribution of your assets after you die. Because a person's assets are transferred to their Living Trust during their lifetime, the inconvenient and lengthy probate procedure is avoided entirely.

In conclusion, the LLC and Living Trust work together to protect, as well as preserve your assets. They can be created at the same time or independently of one another, and both can be modified or dissolved at any time by the owner. Given their tremendous usefulness, all landlords should seriously consider utilizing these legal instruments for the benefit of themselves and their families.

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