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# A PRIMER ON LLCs FOR **RENTAL REAL ESTATE**

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# IS INSURANCE ENOUGH?

**F**rom a legal perspective, real estate activities are a liability magnet putting them near the top of the liability scale. This is because the law treats you, the property owner, as the guarantor for the safety of your tenants and those who enter the property. If anyone is injured on a property for any reason, and regardless of fault, the owner will generally be held responsible. That is a big legal burden. It is easy to see how lawsuits proliferate in this type of system.

Unfortunately, most investors fail to adequately appreciate the risk real estate poses. Many investors continue to operate under the assumption, often reinforced by CPAs or inexperienced attorneys, that when it comes to asset protection, insurance is all the protection they need. Putting your faith in this false deity is sure to bring you trouble down the road.

It is fair to say that most investors own a liability policy, but when asked about it, they can't tell me what is or is not covered under their policy. I know because when confronted with the "I am protected with insurance" argument I always ask, "Do tell

me to what extent?" My typical response is "Huh! I know it's not fair to ask the question because if you turned it around on me, I doubt I could provide any better an answer."

You are probably wondering why an asset protection attorney and an avid real estate investor could not provide a better answer to a seemingly simple question that obviously falls within the legal realm of contracts. My answer for you is I carry insurance on my properties with eyes wide open knowing that my carrier is not in the business of paying out on claims but on

collecting premiums. The carrier's job is to disclaim as much as possible while maximizing premiums collected. Because of the multiple exclusions contained in liability policies (e.g., mold, environmental hazards, abuse, intentional acts, floods, contract disputes, damages resulting from controlled substances, undisclosed effects on the sale of property, etc.), I have placed my faith in the limited liability company to provide me liability protection, which, in case you didn't know it, comes in two forms.



## ABOUT THE AUTHOR

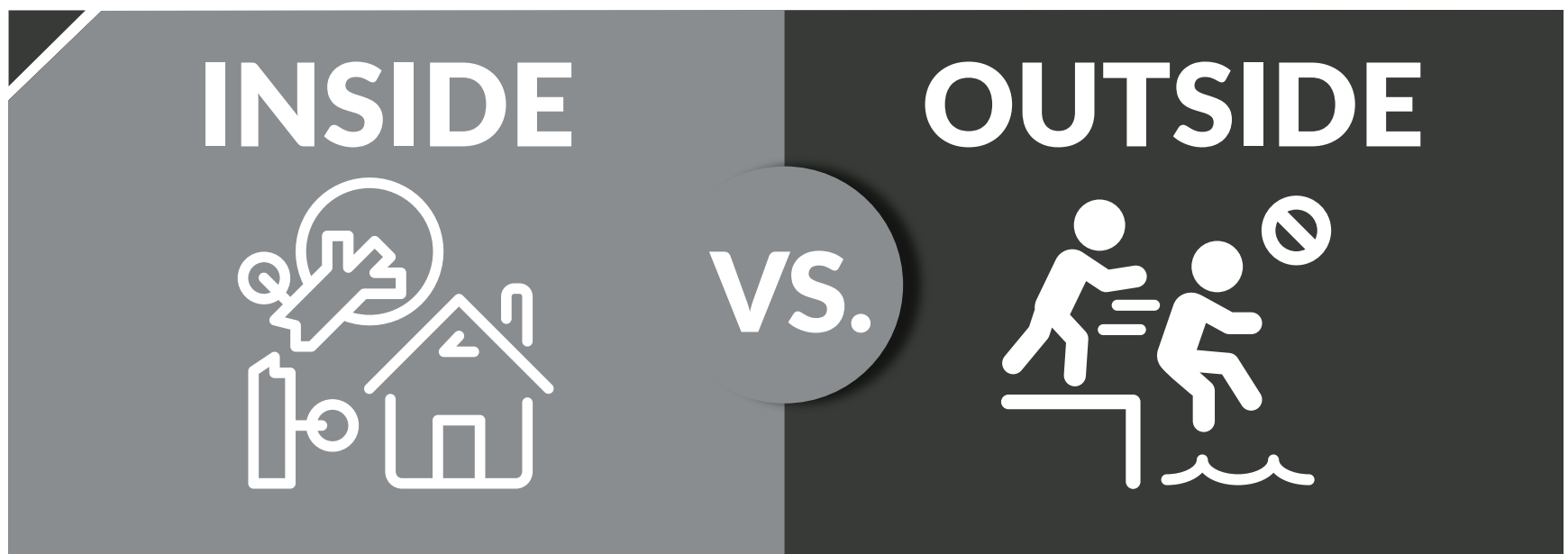
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# INSIDE AND OUTSIDE LIABILITY

The key to properly structuring real estate activities is understanding the concept of *inside* and *outside* liability.



**INSIDE LIABILITY** is a risk posed by the property itself, e.g., the UPS deliveryman is delivering a package to your house and he suffers injuries when he slips on your moss-covered steps. In this instance, your property was the cause of the harm and it will result in you being sued. Such a lawsuit will create some amount of jeopardy for your other properties and assets. Thus, the first goal of asset protection planning for every real estate investor is to insulate and shield you and your assets from any liability arising out of your real estate investments.

*THE FIRST GOAL OF ASSET PROTECTION PLANNING FOR EVERY REAL ESTATE INVESTOR IS TO INSULATE AND SHIELD YOU AND YOUR ASSETS FROM ANY LIABILITY ARISING OUT OF YOUR REAL ESTATE INVESTMENTS.*

**OUTSIDE LIABILITY** is the risk presented by your other activities or those of your family members, e.g., your son pulls his friend behind the four-wheeler you bought him for his 14th birthday and the friend is injured when he falls off his skateboard. A lawsuit resulting from your personal actions poses a potential threat to all of your holdings, including the equity in your properties. The second goal of asset protection is to protect your investments from outside risks.



# LIMITED LIABILITY COMPANIES

The good news is that the limited liability company will protect you and your investments from both forms of liability. How?

Let us review the basic features of the LLC:

## MEMBERS ARE PROTECTED

In an LLC, the owners are referred to as members. The law states that no member is personally liable for the obligations of the LLC. In other words, if the UPS driver had slipped on property owned by an LLC, it would be the LLC that is liable to the UPS driver and not the LLC owners (inside liability protection).

## MANAGERS ARE PROTECTED

An LLC can be established as either Manager-Managed or Member-Managed. The difference should be self-evident. A Member-Managed LLC is one in which all of the members participate in managing the LLC's activities. A Manager-Managed LLC is one in which the LLC members turn over control to one or more managers. In either case, the law states that the manager(s) is/are not personally liable for the obligations of the LLC.

I prefer the use of Manager-Managed LLCs for my clients for the following reasons:

- Most states do not require the LLC to publicly disclose its members, only the manager(s). If you do not want your LLC ownership available to anyone with a computer, then electing to file your LLC as Manager-Managed will limit the information available to the public.
- Member-Managed LLCs give all the members a vote on LLC matters. This can at times be administratively difficult when trying to run a business where each member is part of the decision making process.

## AN LLC CAN ELECT ITS FEDERAL TAX TREATMENT

A major advantage of the LLC in real estate investing is the ability to elect disregarded or partnership tax status. Either election allows all income or loss to flow directly



through to the Member's tax return. An added benefit of this treatment is the ability to remove and contribute assets to your LLC without triggering a taxable event. This is a major deterrent to holding real estate long term in C or S corporations. Additionally, if it is structured to be disregarded for tax purposes, no federal filing is required. For any investor with multiple LLCs, this can be a tremendous annual cost saving.

**AN ADDED BENEFIT OF SELECTING YOUR LLC TREATMENT IS THE ABILITY TO REMOVE AND CONTRIBUTE ASSETS TO YOUR LLC WITHOUT TRIGGERING A TAXABLE EVENT. THIS IS A MAJOR DETERRENT TO HOLDING REAL ESTATE LONG TERM IN C OR S CORPORATIONS.**

# PROTECTION FROM INSIDE LIABILITY

If the law holds the property owner liable for tenants, those who enter the property, or damage created by your property as in the case of a leaking oil tank, then no one should own property in their own name. **The risk is too high.** To protect oneself from liability, real estate investments should be held via LLCs. When you transfer real estate into an LLC and you become a Member, you are no longer liable under the law for claims regarding the transferred real estate. The LLC, as the owner on record, becomes the responsible party. You as the LLC Member are protected.

**From an asset protection standpoint, it doesn't get any better than this.** With an LLC, you can own real estate without the personal liability risk. In addition, because the LLC can be treated like a partnership or ignored for federal tax purposes, you can maintain favorable active or material tax participation status.

## MULTIPLE PROPERTIES AND INSIDE LIABILITY

With multiple properties, the question is often asked, **"Should each property have its own LLC or should they be grouped together?"**

### OTHER ITEMS TO CONSIDER WHEN DECIDING HOW MANY LLCS TO CREATE ARE:

- *RENTS*
- *TENANTS*
- *OVERALL PROPERTY RISK*
- *INSURABILITY*
- *NUMBER OF TENANTS*
- *FUTURE PLANS*

The answer is... **it depends.**

If an investor owns three properties, A, B, and C, and each with \$250,000 in equity, what would be at risk if all three were transferred into one LLC? Everything!

If a tenant in property A is injured, he will sue the LLC, which then has exposure for everything it owns. In other words, all three properties (a total of \$750,000 in equity) is at risk.

On the other hand, if each property is in its own LLC, if something happened at property A, there is no risk of loss for the remaining properties. **Therefore, the**

**answer to this question often comes down to the investor's risk tolerance level.**

Ideally, one property per LLC provides the greatest protection because you are isolating each property from the liability of the other, but this should be balanced against the overall equity you are protecting. In the above example, if each property had only \$15,000 in equity, then placing all three properties in one LLC might make sense from a risk standpoint.

# PROTECTION FROM OUTSIDE LIABILITY

The LLC is a great choice for protecting you from your assets, but what happens if it is you who caused the harm rather than your real estate? In this situation, the law will hold you responsible to the injured party. If a successful lawsuit is filed against you and a judgment is entered, everything you own in your personal name will be at risk.

## Or will it?

A personal judgment creditor has many options when it comes to enforcing his judgment and levying on your assets. One asset your judgment creditor will be troubled with is your LLC Membership interest. **Most state laws** provide that a Member's personal creditor cannot levy

on and take the Member's interest in his LLC. I use the term "most states" because a handful of states do in fact allow a Member's creditor to take his membership interest. This is referred to as judicial foreclosure. We protect against this with an additional layer of protection for your LLCs. The states that do not allow judicial foreclosure only permit a "Charging Order" against your interest.

## CHARGING ORDER PROTECTIONS

A charging order acts like a lien on your LLC interest. If and when you decide to take distributions, the funds must be paid to your creditor until the "Charging Order" is released.

The key phrase is ***"if and when you decide."***

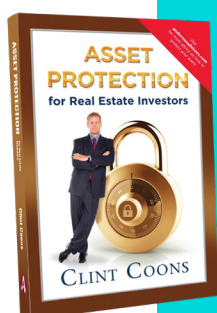
With an LLC, you are in control of the funds. If a creditor is hovering around your membership interest then it stands to reason you will not take a distribution.

## ***Does this imply your funds are locked up?***

Absolutely, from a creditor's point of view. But you are in control, so why not loan yourself some money or pay a management fee? Either one is not considered a distribution and gives you access to the cash.

# CLOSING ARGUMENT

Investing in real estate can be a risky and lawsuit-prone activity. The LLC provides an excellent vehicle to shield your assets from your liabilities and you from its liabilities. As an avid real estate investor and an attorney, a properly structured LLC is my primary asset protection vehicle. If you would like a free copy of my book *Asset Protection for Real Estate Investors*



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