Tools of Wealth Newsletter

Putting Property into an Entity

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By Lee R. Phillips, JD

Don't Go Overboard

The use of entities is being touted in the real estate investment world as a way to achieve asset protection. The lawyers all agree, because they don't get paid until they create the entity for you. In fact, why stop with one entity? Why not a dozen entities? The lawyers will stack them as wide and as deep as you will let them. One to flip, one to hold, one to manage, one in Nevada, one in Alaska. One plus one plus one, and why not another one just for good measure?

I had two doctors come to me and ask if asset protection was really worth it. A nationally noted attorney had gotten a grip on them and had "set them up" with an asset protection plan. They had 53 California rental units in their local area. The attorney had assured them that the way to do asset protection was to have a separate family limited partnership (FLP) for each one of the 53 properties. The attorney very carefully explained that California charged $850 per year as a registration fee for each FLP.

Because it was so expensive to have an FLP in California, the attorney suggested that the doctors form their FLPs in Utah where the fee was only $12 per year. Of course, the doctors would have to have a registered agent in Utah, so since the attorney was already in Utah, he would act as the registered agent. In fact, this attorney had an accounting degree in addition to his JD, and that meant he was totally qualified to set up the FLPs, act as registered agent, and even prepare the tax returns and just give the doctors their K1s each year.

Just to be a great guy, the attorney only charged the doctors $5,000 to set up an FLP. That's $5,000 X 53 = $265,000. Plus, as registered agent and tax preparer, he only charged $1,500 per FLP per year ($1,500 X 53 = $79,500). To top things off, the attorney had a single corporation acting as the general partner for all the FLPs. The poor doctors called me and asked if they really had to keep doing all this asset protection stuff. They wanted to know if there were any way they could unwind what the attorney had gotten them into. Actually, they said they weren't worried about asset protection any longer. It seems they didn't have any assets to protect anymore – the attorney had all their assets.

Maybe Not an FLP

To begin with, the attorney had used the wrong tool. The FLP is OK. I use one in my personal structure. Fifty years ago, it was the tool of choice. (I set up my structure over 30 years ago.) The limited partners are limited in any loss they could suffer to the loss of their investment. The other limited partners and general partner are protected when one limited partner loses their partnership interest, because by law limited partners don't have any say or control in the operation of the limited partnership. Therefore, a creditor that gets one limited partner's interest is silent, but they get any profit or loss distributed to the limited partner.

Note that there is a general partner in the FLP, and the general partner is "personally liable" for all the problems that occur in the FLP. Thus, the corporate general partner was used to protect the doctors from the personal liability. In the old days, it was very common to have a corporation act as the general partner for the limited partnership. That way there wasn't a "person" caught in the general partnership position and no person was in the "personally liable" spot.

The corporate general partner really doesn't solve the asset protection problem, and it adds a lot more cost and complexity to the structure. Corporations don't have charging order protection, so the corporate general partner can be attacked by the personal creditors of the corporation's stockholders. Usually only one or two folks own the corporate general partner, so there is a real chance the general partner corporation can be taken over by personal creditors of the stockholders. Of course, the general partner controls the partnership.

So, why deal with the added corporate entity and all of its ramifications? Today, you should probably use a limited liability company (LLC). There isn't any exposure to personal liability for anyone in the LLC. The LLC offers the corporate shield **and** the charging order protection. There are very few reasons to even consider the FLP today. Plus, the LLC can be taxed any way you choose.

What's the Cost?

Actually, it doesn't matter what entity you use for asset protection. There are big economic ramifications any time you put property into an entity. Let's look at the economic ramifications

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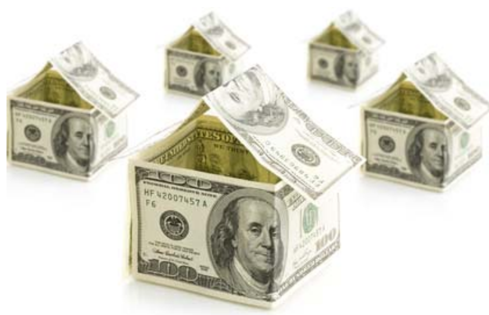
of using an LLC, FLP, or even a land trust with an LLC as a beneficiary.

In the case of the two doctors, they were actually in more trouble than just paying the lawyer each year. Had they actually been sued, they would have had a rude awakening. Their Utah FLP would not have been recognized by California. Their property ownership would have been classed as a partnership, because to be a recognized FLP entity in California, each FLP would have had to register in California and pay the $850 registration fee. That means they would have had to pay the Utah fees (plus the attorney's registered agent fees), and they would have had to pay all the California fees too.

If you have an entity, such as a Nevada LLC, that owns property in another state, that entity will not be a "citizen" of the state where the property is located – unless it is registered in the state and pays all the fees. If the entity isn't registered in the state, the entity doesn't have any legal rights in the state. There is no asset protection.

The corporate "shield" or "veil" protection is a "statutory" protection. It is specifically provided by state law. The corporate shield is a gift from the state for registering in the state and paying them money. No registration – no corporate shield protection! Without being recognized by the state, the entity can't sue anyone or avail itself of any right in the state. That means if the tenant doesn't choose to pay the rent, the owner can't evict them.

In spite of all the arguments that the Nevada guys will make, there isn't any need for a Nevada corporation if the property is in Ohio. Just form an Ohio corporation or LLC to begin with. When you register the Nevada entity in Ohio, you are agreeing to submit to all Ohio laws. You will pay taxes in Ohio on all income derived within the state. If you think being a Nevada entity protects your identity, you'll blow that "anonymity" when you register the entity in Ohio. The real owners must be disclosed in most states. So when you register in your state, all the arguments for Nevada (or any other state) basically evaporate. You'll be asking yourself, "Now, why was the Nevada entity established in the first place?"



By the way, if you have an entity in the state where you live, you will most likely be the registered agent. The only thing the registered agent does is provide a signature when the sheriff shows up with a lawsuit. Almost anyone can be the registered agent. You just have to be sure that when the lawsuit does come, you get it immediately. If a friend or relative lives in the state where you want to have your entity located, then they could act as the registered agent for you. They just have to be responsible enough to get that lawsuit to you fast when it is delivered to them. You only have a few days to answer the lawsuit, or you lose. "My registered agent forgot to tell me," isn't going to be an excuse the judge will accept.

I don't really want to get into all the discussions about where you should form your entity. That's another full article. What I do want to discuss is what happens to your taxes, mortgage and your casualty insurance.

Is Your Insurance in Trouble?

As soon as you put a property into an entity, it changes its nature. It is no longer your property. It is property owned by a business entity. Yes, there is the exception for a property placed into a living revocable trust. The trust has to be a "grantor trust" for the exception to apply. A grantor trust is revocable. Plus, to be a true grantor trust, the "grantor," trustee, and beneficiary all have to be the same person(s). That means technically a land trust that has a third party trustee and/or beneficiary doesn't qualify as a grantor trust. Yes, today everyone is treating a land trust it like a grantor trust. But technically, that may not be correct.

The federal law that says a grantor trust is "invisible" for mortgage, tax, and judicial purposes is 12 U.S.C. §1701j-3 (d)(8). It says you have to remain the beneficiary of the property to get the exception. So you need to be aware of the fine points to the exception to make sure you don't get trapped by the insurance company.

It is very popular to transfer property into an LLC or a land trust. What happens to the insurance? Prior to putting the property into the entity, you got an insurance policy. When the property is transferred to the entity, it is no longer your property. This includes real property and personal property, such as a car. The contract you made with the property and casualty insurance is a personal contract. It's personal to you. When the rental unit burns down or the car crashes, the casualty insurance company will always check the ownership records. If the ownership records don't match up with the policy, there is no insurance. After all, the insurance company insured your property, not some property owned by a company.

If you tell the insurance company that you have transferred the property, they will adjust the insurance to a commercial policy from your private investor's policy. Funny

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thing – the commercial policy will be two or three times more costly than your private investor's policy.

Some insurance carriers will make an exception for an LLC where you (or your living trust) are the owner (member) of an LLC. It's an exception you have to apply for and be granted in writing from your insurance carrier. My son and I own a property together. Our carrier wouldn't let us transfer it into an LLC where we were both the owners. However, properties my wife and I owned jointly could be transferred into an LLC, and the carrier would give us an exception to the commercial property rule. You are just going to have to see what your specific insurance carrier will do.

Actually, our insurance carrier would let my son and me transfer the property into the LLC. They just wouldn't insure the property unless we bought a commercial policy for three times what we were then paying for the insurance. Commercial insurance is always a lot lot more expensive than "private insurance. The job of an insurance adjustor is to get out of paying the claim, so you have to cross all the t's and dot all the i's. The sweet words to an insurance company are "NO CLAIM."

The NO CLAIM is easy when the insurance company determines that you have transferred your property into an entity – any entity other than a true grantor trust where you "remain the beneficiary." The NO CLAIM sneaks up on you real easy when there is an auto accident. Is your auto policy a personal policy? The agent or the police will ask, "Where were you going when you had the accident?" If the answer is "I was on my way to Home Depot," then the second question later in the conversation will be, "By the way, how do you make a living?" When you answer rehabbing houses, it's NO CLAIM. You were on a business run, not a personal run.

When you rent a car, your personal car insurance will cover you when you are on vacation. However, when you have an accident in the slums of Detroit looking for the good real estate deal, it is going to be hard to say you were on vacation. NO CLAIM!

You also need to be careful to instruct your employees to answer questions right. If they are in an accident going to the post office after work to drop off your mail when they are headed home, they had better answer the questions right. The answer to all questions is they were simply going home. As soon as they say they were going to the post office to drop the work mail, it's NO CLAIM. Your insurance won't cover them, and their personal insurance won't cover the accident.

Those insurance guys are really sneaky. The mortgage industry is another story whenever a property is transferred into an entity. That's another newsletter. Suffice it to say, I think a lot of real estate investors are going to be in a lot of trouble when interest rates start to go up. It isn't a question of if interest rates go up. It's only a question of when, because you can't triple M1 (basically, the money printed) and not devalue the currency. ■