

Asset Protection Planning for Real Estate

The basic idea behind asset protection planning for real estate (other than the family home) is to create a legal separation between you and the real estate. This can be accomplished with a Limited Liability Company (LLC). LLCs can also be great vehicles for privacy and for tax and estate planning. The more properties you acquire, the more likely you are to become the party to a lawsuit on one or more of the properties. Putting an asset protection barrier between you and your real estate should be a top priority as soon as you acquire any commercial or residential rental real estate.

There are a variety of ways in which a property owner can lose their hard earned assets to even just one successful lawsuit. Some typical causes are injured tenants, delivery people, guests on the property, neighbors, criminals, children wandering on to the property and getting hurt, or even a city repairman. All it takes is one devastating event, and you could be wiped out.

A person on the property could slip and fall or a balcony could collapse. Not to mention that buildings do catch on fire and mold can grow in the strangest places and cause extreme damage not just to the property itself but to its inhabitants. You can be sued not just for things you are aware of but also for things you “should have” been aware of. A court could decide that you should have known to repair the property to prevent the harm that resulted.

It is not uncommon for a new client to come into my office owning real estate either outright in their name or in the name of their revocable trust. The problem is that if they are successfully sued, the whole of their assets are subject to satisfy that claim or judgment. So when I see a situation like this, I immediately ask about their insurance liability coverage on the properties, whether they have an umbrella policy, and if they know they should set up a Limited Liability Company (LLC) to shield their other assets from a future claim.

Ideally, for the best asset protection, you want to place each rental or commercial property in its own separate LLC. The reason is that if a claim arises on one property, it will not take them all down. If they are all in the same LLC and a major judgment against the LLC occurs, all of the assets of the LLC could be subject to satisfy the judgment. This however is a matter of law which will depend upon the jurisdiction under which you form your LLC. Some states have stronger LLC statutes that better protect the owners of the LLC.

For example, some state statutes limit the creditor’s remedy to a charging order. A charging order limits the creditor to the LLC member’s share of distributions, without conferring on the creditor any voting or management rights in the LLC. If the member decides not to make any distributions, then the creditor would not get any either.

After the LLC is properly set up, you will want to change the title to the property to the name of the LLC. Although some lenders on commercial and residential rental property may have “due on sale” clauses buried in their mortgage documents, most rarely exercise them. Most banks are very familiar with the reasons their lenders want to hold title in the name of an LLC and a simple call to the lender can clear up any questions. The bank will likely want to make sure that the LLC is owned by the same parties that are the parties to the loan on the property.

When the deed to transfer the title to the LLC is prepared, you will also need to file a proportional interest statement and a preliminary change of ownership report so you don’t trigger an Assessor’s Office transfer tax or reassessment. After the transfer is recorded at the Assessor’s Office, you will want to assign your right, title, and interest in the LLC to your revocable trust. If you are in need of estate tax reduction strategies, you may even want to set up an Intentionally

Defective Grantor Trust and transfer a portion of the LLC to that legal entity. However, that is a very complex discussion and goes beyond the scope of this chapter.

Once the property is moved into the LLC, your other assets will be shielded from future lawsuits arising from the property so long as you respect the existence of the entity and keep it in good standing. Only the assets of the LLC could be at risk to satisfy the lawsuit.

Without Asset Protection Planning

Here's an example of what happened to a couple who are real estate investors and did not do asset protection planning:

Bill and Cindy own two residential rental properties in San Diego. The rentals are owned individually in their names as joint tenants. One of the properties as it turned out had some bad wiring and caused a fire in the home. A tenant was killed in the blaze. The surviving spouse of the tenant sued Bill and Cindy in their individual names and was awarded a judgment of \$1.8 million. Bill and Cindy have a \$1 million liability policy on the property and the insurance company paid that amount to the surviving spouse of the deceased tenant. There was still \$800,000 outstanding on the judgment. The surviving spouse started collections proceedings against Bill and Cindy to take their personal residence and all their bank accounts, the other rental property, and their investment accounts. The only thing left untouched was their 401Ks. In a nutshell, they are financially devastated.

With Proper Asset Protection Planning

By contrast, let's look at an example where two real estate investors invested in proper asset protection planning:

Tom and Bob own two rental properties together. Originally, they purchased them as joint tenants. However, Tom's attorney told Tom that he recommended that the properties be held in an LLC so that Tom's other assets would not be at risk if a lawsuit was ever filed in relation to the properties. Tom's attorney also recommended that he assign his interest in the LLC to his revocable trust so that his half goes to his family if he died.

Tom and Bob decided to set up two LLCs since they own two properties. They liked the idea that if something bad happened to one of the properties, it would not affect the other property, and they liked the idea of protecting their other assets.

A heavy storm came through late in January and resulted in the roof collapsing in one of the properties. One of the tenants was killed when the roof collapsed. Tom and Bob didn't know of any problems with the roof, but the court ruled that they should have known that the roof would likely collapse in heavy rain and wind conditions. The judgment was for \$1.7 million, however, the plaintiffs settled for \$1 million because their attorney counseled them that they were limited in recovery to the insurance policy limit and the equity in the LLC.

The property and casualty insurance policy paid the first \$100,000 and the umbrella insurance policy paid the next \$900,000. Tom and Bob only had \$100,000 in equity in the home, but because the home was destroyed in the storm, that equity is gone. Because Tom and Bob properly formed their LLC, put this home in its own separate LLC, and properly maintained the LLC, the plaintiff cannot get to Tom and Bob's other assets outside the LLC.

Proper planning can make all the difference. If you have rental real estate and would like to discuss shielding your other assets from the liability risk that comes with rental real estate, call my Director of Client Services, Lexi Davis, at (760) 448-2220 or email her at lexi@geigerlawoffice.net to schedule an appointment with me.

