

CORPORATIONS AND OTHER ENTITIES USED BY REAL ESTATE INVESTORS FOR ASSET PROTECTION

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(On January 12, 2002, Steve Powanda and I will be presenting a seminar on structuring and use of legal entities for the holding of real estate. This is the advanced seminar, and will be covering some of the following topics, among others.)

By now, most of you have heard about some of the basic principles of asset protection. Hopefully, all of you understand that you want to keep assets that don't have any potential liability associated with them, such as your stocks, bonds, certificates of deposit or other similar investments safely separated from your assets which can have liability associated with them. The latter types of assets include ownership of your business, automobiles, and, of course, investment real estate. For investment real estate, many of the liabilities you can be exposed to by ownership can be dealt with through the purchase of adequate insurance.

How much insurance is adequate? That depends on the value of the buildings, your equity in the buildings, and other assets you are trying to protect. Generally, \$100,000.00 or \$300,000.00 is not enough coverage to persuade a Plaintiff who has sued you on a substantial matter to give up their efforts to collect against you personally over and above the insurance. Most of the time, we recommend a minimum of half a million dollars to a million dollars in coverage. You will find that the difference between the premium for a \$300,000.00 policy and a \$500,000.00 policy, or a \$500,000.00 to a \$1,000,000.00 policy is not that substantial. The lowest level of insurance is that which costs the most, and the highest level of insurance is that which costs the least. This is because

small claims are substantially more likely than policy limits claims over \$1 million dollars.

However, not all liabilities can be insured against by your business or property insurance coverages. What types of liabilities are not covered? The first and most likely liability you will read about is lead paint liability. A few years ago, most insurance companies did not have a clear exception for lead paint liability. However, after the first of these cases came along, most renewal policies included provisions excepting any claim based upon hazardous waste or hazardous materials found in the property. This policy language has been interpreted to eliminate coverage for lead paint liability. Other types of liability that may not be covered by your insurance include liability for unfair housing practices. If you refuse to rent to a tenant because of race, religion, national origin, sex, or, in the City of Pittsburgh, sexual preference, you are violating the fair housing practices laws and can be subjected to an action before the Pennsylvania Human Relations Commission.

Even if the claim you face is a simple slip and fall covered by your insurance, you do not want to be named individually as the Defendant in a lawsuit. This can interfere with your credit and is a matter of public record.

Use of entities for the ownership of investment real estate can also be beneficial for privacy reasons. If you own property in your own name and your tenants know it, the buck stops with you when it comes to any type of repairs or improvements requested by the tenants. Your relationship with the tenants will be much better if you are introduced to them as the manager, sign the lease as manager on behalf of an entity, and have a phone number for the tenants to call with problems, which number is identified by the name of the entity.

Tenants are less likely to call in the middle of the night or weekends or holidays if they expect that they're dealing with a management company and not the individual owner of the

property. This can give you some added peace and quiet during those times.

Once you cover the basics and understand why you need entities to hold investment real estate, the burning questions are which entities work best and how many different entities and what combinations should you use to balance your asset protection objectives with the underlying objective of owning investment real estate to make money, not to pay additional taxes, accounting and legal fees and incur additional time running extra structures. The entities available for holding real property in Pennsylvania include corporations, which can either be SubChapter S or SubChapter C corporations; Limited Liability Companies or “LLCs”, which can also elect to be taxed in the same manner as S corporations; general partnerships; limited partnerships; and trusts, including living trusts and business trusts. Each of these entities has its own advantages and disadvantages in both tax considerations and asset protection liability issues. To a substantial degree, it depends on how you intend to invest in real estate which options are better for you. For example, an investor who intends to buy and wholesale properties to other investors is likely to consider different legal structures than an investor who is buying properties to hold them long term and rent them out, and either of these investors is likely to consider different options than an investor who intends to buy single family homes and enter lease options or rent to own agreements to allow the purchase of those properties by the occupants on an installment basis.

Sometimes, a combination of entities may have advantages over a single entity. For example, the use of an S corporation or LLC as the general partner of a limited partnership eliminates the personal liability an individual general partner would face, but preserves limited liability for the individual limited partners. The combination also has the benefit of reducing the capital stock tax

which would apply if the limited liability company or S corporation held the property directly. If a corporation holds property directly the capital stock tax payable by that corporation will be affected by both the asset value of the property and by the income attributable to that property. However, if the corporation owns only a 1% interest in the limited partnership which holds the property, then only 1% of the asset value and 1% of the income will be included in the corporation's capital stock tax calculations.

This saves 99% of the capital stock tax which would otherwise be paid. However, someone who was engaged in the quick turn sales of real estate would not necessarily want a limited partnership, because post dissolution liability potential for limited partnerships is greater than the post dissolution liability potential for a corporation which owned real estate directly.

Also, someone who is holding property for an extended period of time will have to accept the liability for any defects in the design or construction of improvements made to the property during the term of their ownership. However, someone who is quick turning properties will not want to have extended exposure for claimed defects in the design or construction of improvement to that real estate during the brief period when they own the property. One way to help to reduce that liability is to shut down the entity that owned the property when you have no reason to expect that there will be any liabilities. The rules concerning corporations are most favorable to investors doing this, and we believe that the case law involving LLCs will develop similarly to corporations. However, if you own the property individually or keep the entity which performed the quick turns open, you or the entity can be exposed to liability for design or construction defects for up to twelve (12) years after the design or construction was completed.