

**Protect Your Property from the Lawyers
Clark Allison, Esq.**

Owning rental properties can be a tremendous investment. For a minimum down payment, the right property can yield rents equal or greater than the mortgage and management expenses, and the taxes from the rental income can be offset by depreciation. In addition, the property will appreciate over time. When you decide to sell, you can exchange the property for a different property and pay no capital gains on the transaction. No other investment offers these advantages. However, while the benefits of owning rental properties are significant, the risks are great. Without proper planning, the risks can outweigh the benefits.

Stay Off of the Litigation Train

Over 80 million lawsuits are filed each year in the U.S. Each year trial attorneys create new causes of action aimed at the perceived deep pockets of businesses and individuals. You are familiar with the results: the McDonald's hot coffee case and most recently, the mold cases. *The San Francisco Chronicle* reported on January 22, 2003, that tenants of an apartment building in Hayward are suing the owner for five million dollars for mold related injuries. Mold damage awards in recent cases have been so great that the major property insurance companies are reluctant to write policies in California.

It used to be that you did not get sued unless you did something wrong. Today, this is not the case. The prevailing ethos is if something bad happens someone must pay. The "someone must pay" attitude is encouraged by the legal system. The litigation playing field is not level. Plaintiffs' attorneys take contingency fees resulting in plaintiffs getting a free lawyer. The English rule of "loser pays" doesn't apply to personal injury cases. Once you've been sued, you've lost. You have to pay an attorney to defend the suit, and even if your insurance company pays for the defense, you must spend time and emotional energy as the defendant.

Proactive planning can significantly reduce your risk of being a defendant in a lawsuit. Understanding the risks inherent in the way property is owned will help you see that planning is crucial for your protection.

Rule One - Do Not Own Rental Property in Your Name

Owning rental property in your name is not wise. Any lawsuit related to the property will be directed at the owner. Two types of risks can affect rental property: inside risks and outside risks. Inside risks include risks related to the property such as injuries to tenants and their guests and damages to the tenant's property. Outside risks are risks unrelated to the property such as a

car accident, a business transaction, a business injury or a malpractice claim. If you are sued for a risk unrelated to the property, all of your personal assets will be exposed, including all property owned in your name.

Joint Ownership

Many people own property with a relative or friend. This form of ownership is called tenancy in common. Each owner owns an undivided share of the property. Joint ownership with a right of survivorship is similar, except when one of the owners die, the surviving owner gets the deceased owner's share. Both forms of joint ownership create much more liability than if you owned the property in your name alone. If one owner is at risk for lawsuits and claims for outside risks, then multiple owners multiply the risk. If you and your friend own a property and he is sued and loses, the plaintiff could get your friends' share of the property and become your new partner. With joint ownership, your co-owner's risks become your risks.

Community Property

In California and eight other states, assets acquired during marriage are community property of the spouses. Each spouse owns one half. While this is often a fair division of assets, it presents problems. Property owned as community property is subject to the creditors of either spouse. If the husband is sued and loses, the wife's share of the community property may be fair game for the plaintiff.

Rule Two - Limit Your Risk

Thoughtful planning can significantly reduce your risk by providing a structure to better protect and manage your property investment.

Your First Step - Obtain Insurance

A good insurance policy can provide a solid first line of defense. However, you must be aware of its limitations.

General business insurance policies insure against accidents on the business property such as slip and falls and fire and equipment malfunction. These policies often exclude accidents occurring outside the scope of employment, an intentional act by an owner or employee, contract claims and working at home.

Liability policies for professionals such as doctors, dentists, attorneys, architects, engineers and accountants also have exclusions from coverage such as grossly negligent acts, willful or wanton misconduct, punitive damages and liability related to product liability.

Personal liability insurance policies include auto, homeowners and umbrella coverage. If a plaintiff's damages exceed your auto policy limits, you will be personally liable for the balance. Homeowner's insurance policies provide insurance for damage to the residence caused by acts of God, insects and

often construction defects. The policies often exclude coverage for any business activities at the home.

Umbrella insurance policies are a relatively inexpensive way to supplement auto and homeowners policy limits, but they are not complete. Umbrella policies generally exclude coverage for dangerous sports, dangerous equipment such as guns, trampolines, swimming pools and sometimes lawn mowers, chain saws and power tools. In addition, such policies may exclude dog bites, intentional acts and business activities.

Another problem with relying exclusively on insurance is the risk that your insurance company may not be in business when you file a claim. The Wall Street Journal reported on January 30, 2003, that a rash of insolvencies among insurers is resulting in hundreds of thousands of consumers at risk of not collecting on their claims. The problem is growing as more and more insurance companies are filing for bankruptcy. While insurance is a good first step, it is not sufficient.

Your Second and Best Step - Use a Limited Liability Entity

The best way to own rental property is in a Limited Liability Entity (LLE) such as a limited liability company or limited partnership. Instead of owning property in your name or with a partner, you can establish an LLE and transfer title of the property to the LLE. The LLE now owns the property and you and/or your partners own the LLE. This common transaction will provide substantial benefits.

Protection from Inside Risks

When an LLE owns property, your personal exposure for inside risks is limited to your investment in the LLE. If a tenant sues, he can't get to your personal assets, such as your house and bank accounts. The LLE statutes limit his recovery to your investment in the LLE. By owning your property in an LLE, you will limit your exposure to inside risk and protect your other assets.

Protection from Outside Risks

If you lose a lawsuit, the plaintiff receives a judgment against you and becomes your judgment creditor. The judgment creditor cannot reach the LLE property because it is protected by statute. In most cases, all a judgment creditor can get from the LLE is a charging order. A charging order does not give him control or management rights over the LLE nor does it allow him to reach the LLE property. A charging order only gives the judgment creditor a right to receive your share of LLE profits.

If the LLE has a net income after expenses, you or you and your LLE partner must elect whether to distribute the income to yourselves or use the income for capital improvements to the property. If the LLE makes no distributions to its owners, the judgment creditor gets nothing.

If a charging order has been levied against your LLE interest, it may be in your best interest to elect against distributions. You won't get income but neither will the judgment creditor. In fact, he may even have to pay your share of LLE income taxes.

An LLE is a pass-through entity. It does not pay taxes, its owners do. If the LLE has net income, whether it is distributed or not, its owners must pay income taxes on his proportionate share. Here are two examples to clarify the point.

Example 1

Acme LLE has 3 equal partners. The LLE net income is \$60,000, which is distributed equally to each partner. Each partner is then responsible for taxes on \$20,000, which will be reported on their 1040 return.

Example 2

Acme LLE nets \$60,000, but reinvests the income into property improvements. The partners don't receive a distribution, but each will still be responsible for the tax on their share of the LLE income which is \$20,000. If the LLE has net income, the owners pay tax whether or not they actually receive their share of the income. The holder of a charging order has a right to profits, therefore, the IRS may consider him responsible for the taxes, not you. This concept will likely turn a charging order into a poison pill for the judgment creditor.

Example 3

Judgment Creditor has a charging order against Joe, a partner in Acme LLE. Acme has a net income of \$60,000, which the partners decide to reinvest in improvements to the properties. Judgment Creditor is responsible for taxes on Joe's \$20,000 although Judgment Creditor received no distribution of income.

If you own your office building, you should implement this strategy and establish an LLE to own the building, and then your business can lease the building from the LLE. This will give you better asset protection and reduce your taxes. See my article **Keep It and Protect It! Tax and Asset Protection Strategies for Small Business Owners** for a discussion on the tax savings.

A judgment creditor with a charging order has a right to your share of the LLE profits. However, even if he receives no distributions, he may be saddled with your share of the taxes. With no right to reach or sell the LLE property, no LLE management or control rights, no guarantee of LLE income, and a potential tax liability, a charging order is not a desirable asset. If a plaintiff understands the diminished returns of a charging order, he may think twice

about bringing the lawsuit. If a plaintiff goes forward and wins, he may likely be willing to settle for a reduced amount rather than face potential tax liability on income he may never receive.

A properly drafted LLE is not a foolproof protection against lawsuits, but it will better protect your income property and your personal assets. It will also significantly improve your position against a plaintiff and judgment creditor. Proactive planning is the only planning that works. If you wait until you are sued, it will be too late. Once a claim or suit is filed against you, your property is exposed. Plan now and protect the many benefits of owning rental property.

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Feel free to contact us for a consultation at info@ukohalaw.com