The Real Estate Investor's KISS Guide To Entities

by John Hyre
Tax Attorney, Accountant & Investor

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What is an Entity?

An entity is an organization that exists only on paper. It is a creature of the law, meaning that it only exists because the law says that it does. The best way to understand the concept: An entity is a "contract" between you and the state. You and the state agree that if you do certain things, the state will do other things in return. For example, if you:

- Inform the state that you are entering a "contract" with it;
- Pay the state a fee to recognize and publicize the "contract"; and
- Conduct your business in a certain manner (e.g. – hold annual meetings, pass resolutions, do not cheat others, etc.); then
- The state will forbid creditors from seizing assets that are not part of the business; and
- The state will tax the business in a certain manner.

Unlike most contracts, the agreement between you and the state is not in the form of a written agreement (that would be far too simple!). Instead, the law sets forth the terms of agreement (e.g. – you must file Articles of Organization, pay a fee, etc.). Sometimes the law is quite clear on what you must do (e.g. – the state prescribes a specific form, such as the Articles of Organization, for you to use when entering into the contract / creating the entity). Other times the law is not so clear (e.g. - How much capital does your business need for the state to respect it? Answer: It depends!). In those cases, the courts decide whether the contract is to be honored, based on the specific facts in each case.

There are several different types of entities. The ones that we deal with here are:

- C-Corporations;
- S-Corporations;
- Limited Liability Companies ("LLC's"); and
- Limited Partnerships (LP's).

In essence, each type of entity constitutes a distinct kind of "contract" offered by the state. Each type of "contract" has its own distinct set of benefits and burdens. Which "contract" (type of entity) is best for your business? It depends on a large number of facts, including:

- How much money the business makes;
- What kind of income the business generates (e.g. – Rental income? Sales income? Interest income?);
- How the business spends its money;
- Whether the business reinvests or distributes its profits;
- How much the business' owners make;
- What kind of income the business' owners generate;
- How the business' owners spend their money;
- Whether the business uses leverage;
- Where the business resides; and
- Where the business' owners reside.

The list goes on. The point: Deciding which entity/"contract" to select for a given business depends on a large number of details. Anyone who attempts to assist you in selecting an entity type for your business without knowing the details of your financial situation is probably doing you a serious disservice.

To summarize: Entities are fictitious "persons" created and sanctioned by state law. In effect, an entity is a contract between you and the state. The basic terms of the contract: If you agree to run your business in a certain manner, the state will agree to limit the liability incurred by that business to the assets of that business. In lieu of such an agreement, business creditors could seize assets belonging to the business' owners. In addition, the state agrees to tax the business in a certain manner. The state usually offers you a choice among several "contracts" or entity types.

Benefits of Entities

There are two primary reasons to have an entity:

1) Asset Protection; and
2) Tax Savings.

Normally, an attorney can advise you as to the asset protection offered by the various entity types, which entities are permissible for a given activity, and what must be done to maintain an entity without breaking your side of the "contract" with the state.

Because the asset protection features of each entity type are fairly similar, the tax treatment accorded by the federal and state governments tends to drive choice of entity. Choosing a particular type of entity involves the counsel of tax professionals, usually accountants, sometimes attorneys. BEWARE of accountants giving legal advice! While accountants are often competent where tax matters are concerned, they often fall short on legal issues. When choosing, forming and running an entity, you need to work with BOTH an accountant AND an attorney. More than once I've seen accountants make tax decisions without understanding the legal ramifications. Likewise, I've seen attorneys give great legal advice that causes serious tax troubles. To reiterate: You need competent legal and tax help when choosing, forming and running entities! BOTH the asset protection AND the tax features of entities need to be taken into account!

PART ONE: ENTITIES & ASSET PROTECTION

Asset Protection: General Points

All properly-maintained entities provide some degree of *limited* liability for their owners against the creditors of the underlying business.

IMPORTANT: "Limited Liability" is not the same as "No Liability"

Of first importance is the word "limited". Entities are not designed to negate all liability. Instead, they limit, but do not eliminate, liability. This point is extremely important, because attempts to eliminate liability (instead of limiting it within reasonable bounds) often backfire and result in unlimited liability.[1] For example:

Gullible Gary, a real estate investor, owns 10 rental properties, each worth $100,000 with $85,000 in mortgage debt on each, resulting in $15,000 in equity in each property. Get-Rich-Quick Guru proposes that Gullible Gary put each property into a separate LLC. In addition, Gary is advised to create a $15,000 note for each LLC, payable to him. The theory behind the structure is that:

1) Each LLC provides a liability shield, so that if one LLC is sued, only one property is lost; and
2) Gary has pulled the equity out of each LLC with the note, so there is nothing left for a potential creditor to seize.

That's the theory. A likely result if one of the LLC's were sued and lost the resulting lawsuit:

The LLC's liability shield would probably be ignored.[2] Gary would be liable personally for any judgment and his assets (probably including the other LLC's and their assets) would be subject to seizure. This "piercing of the corporate veil" can occur based on a number of legal theories. In this case, the most likely reason for a court to disregard the liability shield is that each company lacks adequate capitalization. That's a short way of saying that a court could live with reasonable attempts to limit liability, but would not favor attempts to eliminate liability. We will cover circumstances that can lead to "piercing the corporate veil" later in this publication. The point: Using entities to limit liability makes sense, while attempting to eliminate liability can backfire.[3]

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[1] Hogs get fat, pigs get slaughtered.
[2] Also known as "piercing the corporate veil".
[3] Not to mention that maintaining all of those entities is probably not worth the resulting expense, as measured in terms of money, time and hassle.

The Basic Liability Shield

The basic liability shield provided by an entity prevents the entity's creditors from seizing the entity owners' assets. If the entity is properly maintained and used for an acceptable purpose, the creditors' sole means of collecting entity debts is to seize the assets of the entity. For example:

Tammy Tenant's child spends 3 years eating the lead paint on the walls of a property owned by Henry's Houses LLC. Tammy sues Henry's Houses LLC and wins a large judgment in court. Damages arising from lead paint are excluded under Henry's Houses LLC's insurance policy.[4] As such, Tammy's lawyer would seize the assets of the business to satisfy the judgment. Because the judgment was against the LLC, Tammy's lawyer could not seize Henry's personal assets.

What's in it for the state? Why does it agree to limit Henry's liability at the expense of Tammy's child? While the result may seem unfair, larger considerations are at work. Specifically, if putting up a portion of one's money meant risking everything, many people would not be inclined to risk anything at all. Businesses would lack for funding, or never get started to begin with, because the potential liability would frighten off potential investors. From a social standpoint, that outcome would be a disaster. Think about it. Businesses provide jobs, invent life-saving drugs and free people from drudge-work (ever try to wash clothes by hand?), among other things. Societies that do not uphold property rights and encourage for-profit enterprise stagnate,[5] fall apart[6] or generate mass misery.[7] Business isn't perfect,[8] but it makes life incomparably better. In a perfect world, kids wouldn't have lousy parents, paint wouldn't be dangerous and honest businessman wouldn't be put into the poorhouse for incidents over which they had little control. Unfortunately, we do not live in a perfect world, so any decision inevitably hurts someone, somewhere. In this case, the lesser of two evils is to promote formation of socially-productive businesses by limiting the liability of the owners of those businesses. As we shall see later on, it also makes social sense to deny liability protection in certain cases.

<u>To summarize</u>: The liability shield of an entity can protect the entities' owners from the creditors of the business. The business may lose its assets, but the owners generally should not lose theirs.

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[4] You will invariably find that to be the case.
[5] The United States in the 1970's.
[6] The Soviet Union in 1991.
[7] Africa today.
[8] And as such, requires a reasonable amount of oversight. The problem with too much oversight: Business isn't perfect, but government is even less perfect. At least business creates wealth instead of sucking it out of productive people and giving it to unproductive people so that they can in turn afford to multiply and vote for yet more government. Too much regulation leads to widespread misery.

Protecting the Business from Yourself

As we discussed above, all entities provide some degree of protection for the owners from the business. In addition, certain entities (LLC's and LP's) protect the business from its owners.

Specifically, when an individual incurs liabilities, the respective creditors can generally seize that individual's assets. Such assets include, for example, shares in a corporation. However, certain assets are exempt from seizure. Importantly, most states prohibit creditors from directly seizing a debtor's interests in an LLC or LP. For example:

Winona Ryder is driving home from the store[9] when she negligently runs over Fifi, a hyper yappy little dog that was momentarily outside of some brainless starlet's purse. Said brainless starlet (hereafter known as "BS") sues Winona for her pain and suffering. After getting a California-style shrink[10] to testify in front of a California-style jury,[11] the BS wins a judgment for five million dollars to compensate her for her horrible pain & suffering. If Winona owns a corporation,[12] the BS can probably[13] seize it.

If, on the other hand, Winona owned an LLC (or LP), BS could not directly seize the company shares in most states. Instead, BS could petition the court to levy the LLC/LP shares for any cash that would be distributed to Winona. Such a levy is known as a "charging order". There are a number of reasons that a creditor might choose to <u>not</u> obtain a charging order:

1. If Winona's LLC were properly structured and had a friendly manager, the manager could conveniently refuse to make any distributions of cash on Winona's shares. As such, the creditor would get no cash.
2. Our good friends at the Internal Revenue Service would treat BS as the owner of any shares upon which she obtained a charging order. As such, BS would get to pay taxes on Winona's portion of the LLC's profits. All that, while being denied the cash from the levied shares....talk about the worst of both worlds!

Suffice it to say, that creditors are not prone to obtain charging orders against LLC's and LP's. Bear in mind, "not prone to obtain charging orders" does not mean "never". There is some disturbing case law out of California[14] that allows creditors to get around charging orders in some cases. Specifically:

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[9] In her own car instead of a police cruiser. Hey, this IS fiction, after all.
[10] Read: Left-leaning, dope smoking, new-age wack-job.
[11] See footnote 10, multiply by 12. Think "OJ Simpson jury".
[12] And presumably has a receipt to prove that said ownership was lawfully acquired.
[13] The common law in some states may provide an alternate remedy for our poor, damaged BS.
[14] What a shock. Another bad decision from drug-addled judicial tyrants.

Business as Usual: California Mucks Things Up

In most states, the law says that charging orders against LLC/LP interests shall be the only remedy with respect to the LLC/LP interests for creditors of the LLC/LP's owners. Unfortunately some courts have the idea that the law is not what it written on the books by the elected legislature. Instead, the law is whatever the court (elected or otherwise) would like it to be. In California, two courts ruled that charging orders do not apply to small businesses. Of course, they couldn't directly say that. Here's the reasoning that got us there:

Charging orders were designed to keep businesses from being disrupted. If a creditor could simply insert himself as a new and obnoxious partner by directly seizing the debtor's shares, businesses would be disrupted and perhaps go under. That would be bad for everybody, starting with the employees who would lose their jobs upon the demise of each business. So each state's legislature enacted the charging order statutes that allowed creditors to try and squeeze money out of a business without destroying it. So far, so good.

The California courts ruled that in a single-member business, there would be no disruption or harm to others by permitting the company's shares to be seized and sold. As such, the California courts concluded that the charging order concept and should apply to single-member businesses. Amazingly, that reasoning makes some sense. The problem: It is not a court's job to engage in or enforce such reasoning. Rather, it is the elected legislature's job. The California legislature could have refused to apply the charging order concept to single-member LLC's. However, it chose not to make such an exception. By creating an exception in the case law, the California courts have usurped power to which they have no right – they are making law instead of interpreting it. THAT is judicial dictatorship. Who suffers the damage of such a ruling? Microsoft? Walmart? Probably not. Most single member LLC's ("SMLLC's") are owned by small businesses. In short, the California court took the law into its own hands, to the detriment of small business owners.[15] Those rulings cast an unfortunate pall of uncertainty over charging orders on SMLLC's everywhere.[16]

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[15] By the way, this sort of abuse by the courts is fantastically dangerous. Unlike the legislatures, the courts (especially the unelected federal courts) are unaccountable to voters. For them to make, instead of interpret, the law is judicial dictatorship, pure and simple. The best known case of law by declaration instead of law by legislation: *Roe v. Wade*. Whatever your opinion on abortion, that case was and is bad law because the court flat-out made it up to get to the result that it wanted. Even you pro-abortion types out there should be appalled by such rulings, because if the courts were to fall into the hands of your enemies, they would legislate against YOU from the bench. Bad, bad, bad, no matter whose ox gets gored.

[16] Some states do allow debtors to foreclose on the charging order and sell the interests in the business. Such foreclosures are rare, because they raise little or no cash for a creditor. That result is due to the fact that few bidders are willing to pay much for a partial interest in a business that probably contains hostile partners.

Structuring to Take Advantage of Charging Orders

The ideal result if a creditor obtains a charging order against your LLC/LP interest: They get no cash distributions. For that result to occur, the Operating Agreement for the LLC or LP needs to provide for shutting off distributions. There are a few ways to do that:

1) The Operating Agreement can provide that no distributions shall be made on a Members' interest that has been encumbered by a charging order.

- Advantages:
  - Such language is simple and would not interfere with the normal operation of the business
  - The creditor bears the burden of persuading a court that another remedy (e.g. – foreclosing on the LLC or LP interest) would be more appropriate.
- Disadvantages:
  - Such language has no independent business purpose. Its sole purpose is blatant asset protection. Courts are more likely to overturn such language than if a separate non-"self-serving" purpose existed for the distribution structure.

2) Distributions are made at the discretion of a manager/vote by the members. The manager is not the same person as the owner of the encumbered interests.

- Advantages:
  - This sort of language is quite common
  - It is simple
  - It is not blatantly for asset protection purposes
  - The burden of seeking an alternate remedy is on the creditor
- Disadvantages:
  - You may not like how the manager (or another member) exercises his discretion
  - You need a separate manager/extra members for this to work. Extra moving parts add complexity and cost. They also increase risk and exposure. Getting an extra member may spruce up this aspect of asset protection, but it will also make liability much more likely to begin with!
  - SMLLC's,[17] by definition, will not be able to do this.

3) Distributions are made based on a formula, with extraordinary distributions or withholding of distributions made upon a majority (or super-majority or unanimous) vote.

- Advantages:
  - Minimizes uncertainty caused by making distributions subject to someone's discretion
  - Clearly sets distribution expectations up front, in writing
  - Not blatantly for asset protection purposes

[17] For purposes of this charging order discussion, I include husband/wife LLC's as SMLLC's. If your spouse is the "manager", they probably do not have much credibility as an unbiased third party!

- The burden of seeking an alternative remedy is on the creditor
- Disadvantages:
  - Other members may not vote to limit your distributions if a creditor attaches your interest
  - Not very credible in a SMLLC
  - If circumstances change or you an extra distribution right NOW, other members may not cooperate

I personally tend to favor option #3, though my ultimate choice will vary based on the circumstances. It is important to understand that the charging order rules provide a major deterrent against creditors attaching interests in an LLC/LP regardless of which option you choose, because:

- The creditor always bears the burden (read: cost) of obtaining a California-style verdict; and
- Such a verdict is far from guaranteed.

In short, the charging order concept can provide an entity's owners with some leverage against creditors and make a favorable settlement much more likely. Like any tool, it is imperfect – but far better than going "naked", where a creditor faces no such obstacles.

Charging Order Summary

In most states, a creditor cannot simply seize a debtor's interest in an LLC or LP. Instead, the creditor is often limited to obtaining a charging order. That option is normally very unattractive to a creditor, because it may get no cash from the levied interests but be forced to pay taxes on the underlying income. The charging order concept does not offer absolute protection, especially if small or single member LLC's are involved. At a minimum, the charging order does put a debtor in a much better bargaining position with respect to creditors, due to the cost of getting around the order (and that's making the pessimistic assumption that a court will permit a creditor to get around the law at all – unlike their California cousins, some courts limit themselves to merely interpreting the law).

How to Maintain the Basic Shield

As we shall see later, setting up an entity is pretty simple. Properly maintaining one on the other hand, is much more difficult. It's very much like having children: The process of creation is fun and easy,[18] raising the kids takes an immense amount of work and time.[19]

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[18] And quick?

[19] And love. I savor every minute of it. I'll probably go nuts 15 years from now, when my full house falls strangely silent.