

A BETTER WAY

Preserving Business Value When Acquiring Real Property¹

By G. Timothy Leighton, JD, CFP®²

As business owners go about building their wealth, it's not unusual to acquire real estate. By being thoughtful regarding *how to own* real estate, you can make choices that should result in better protection and privacy. The result could be a greater likelihood of preserving and growing value in building that wealth. There may also be some tax advantages that follow.

The simple way to buy and own property is to take title in your own name. That is to say, at the real estate closing, the Seller signs a deed which transfers ownership to you personally. That personal ownership could be the business owner individually, or the owner jointly with spouse or business partners or even investors.

Consider, however, some of the costs and risks of this method. Anyone going to the county land records office could quickly find out that you own the property. A creditor, or someone to whom you might owe money in the future, could lay claim to that property as a way to satisfy the debt. Those creditors could include people who sue you in your business, or even unhappy former employees or ex-spouses. In the future, you might want the business to pay you rent for the property when you are no longer actively running the business. And some day you may wish to sell the property or transfer it to your children or future owners of the business. Or in the absence of planning, your estate may have to deal with these issues.

Some people think that an easy way around these issues is to transfer ownership to a relative or close friend who is not active in the business. This "self-help" type solution is frequently a disaster, for one or more of many reasons. First, there are all sorts of tax consequences for such transfers. Second, if your relationship sours with that other person, you may yourself have lost control and benefits. And third, the result is probably not private.

There are several formal structures available to business owners that allow you to keep control, avoid tax problems, and preserve privacy. When planned and implemented with care, they are legal, they are legitimate, and the cost-benefit analysis may result in a decision that you are better off with them than without them. The one seeming to be more and more prevalent today as the first choice is a limited liability company.

Limited Liability Companies

A limited liability ("LLC") is a business entity which provides limited liability protection for its owners, called "members", preserves their control, and offers choices for how to be taxed. An LLC may be an appropriate vehicle for real estate investment, because it combines liability protection with favorable income tax treatment.

¹ **Important note:** *This information is designed to provide a general overview with regard to the subject matter covered. The author and publisher and host are not providing legal, accounting, or specific advice to your situation. You should consult with the professional advisors of your choice for specific advice.*

² *Tim Leighton* is a lawyer and Certified Financial Planner™ who helps business clients plan for building their enterprise and providing for its continuation after they stop being in business.

Real estate ownership can involve all sorts of liability exposure. Various contracts, including mortgages, leases and services, typically involve duties, obligations, and risk exposure. All sorts of state and federal laws also impose these same concerns. Consider environmental rules, duties to visitors, employees, trading partners, and others. And of course, as entrepreneurs build value in an enterprise, they become attractive targets from those who may wish to abuse the jury system for potentially lucrative damage awards.

Another big liability exposure involves taxes. LLCs offer choices on how to be taxed and what is subject to transaction. Taxes can be quite complicated, so entrepreneurs should seek competent, comprehensive advice from their accountants, attorneys, and other advisors. Clients usually benefit when these different advisors communicate with each other and the business owner, working as a team. The major decisions tend to boil down to whether the owners choose to be taxed at the business entity level or whether they instead prefer that taxable income and deductions “pass through” to the members personally.

The LLC helps its members called achieve protection from liability exposure because state law defines that protection. In exchange for consistently and carefully following state-mandated procedures, members have the benefit that assets owned in the LLC are not exposed to the claims of personal creditors. Indeed, there may even be limits to how a creditor of the LLC itself can reach assets inside the LLC.

Control is another major factor. There are other ways to own property that do not necessarily let the entrepreneur maintain control. As mentioned earlier, when an entrepreneur transfers ownership of an asset to a friend or relative, then that new owner has actual control. That’s not a problem as long as everyone stays alive and well and there are no disagreements. But things have a way of changing. Sometimes people consider use of trusts. For trusts to achieve asset protection, they must usually be “irrevocable”. That means the creator can’t change goals unless they are anticipated. Trustees have fiduciary duties to the beneficiaries and must act consistent with the trust instrument. That’s fine as long as the instrument is very flexible or situations do not change. In reality, it is difficult to predict the future.

Finally for purposes of this introduction, consider transferability. At some point, a current business owner will stop being the owner. The challenge is how to transfer business ownership and control to successors. Those successors might be family members or trusted, valued employees who will continue the enterprise. There might be a sale from current owners to new ones. Or the transfer might occur by operation of the probate system following death or incapacity. There is usually greater flexibility and choice, along with reduced costs, when an LLC is the owner rather than one or more individuals. Instead of trying to transfer the enterprise, all that needs to be transferred is membership interest in the LLC.

A savvy entrepreneur who is building wealth through real property should think about the future and consider asset protection, control and taxes. By working closely with a range of professional advisors, the owner can structure the deal to achieve several goals, including reducing risk and transaction costs while increasing profits and value.

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Major Alternatives to Limited Liability Company

1) **Individual or Joint Ownership** - Entrepreneurs take title to real estate in their personal names. On the plus side, this is “how it’s always been done”, it’s simple and quick, and start-up costs are minimized. There are trade-offs, however. Anyone can easily find out who owns the property. Value is exposed to the claims of creditors. At death, in the absence of effective planning, the probate system must authorize the transfer to future owners. All tax issues are covered on the owner’s personal tax returns.

2) **Irrevocable Trusts** - When an irrevocable trust owns property, the value can be sheltered from the claims of creditors. This type of trust is a legally distinct entity, separate from its creator and its beneficiary. Trusts afford substantial privacy with proper planning, including very little governmental oversight in the absence of fraud or abuse. To achieve this type of asset protection, usually the person creating the trust cannot be the trustee. Thus the business owner would have to rely on someone else to follow the rules of the person setting up the arrangement, and may have to compensate for those services. Trust taxation rules are also quite complicated and usually more expensive than personal tax rates. In the right situation, however, this arrangement is very effective.

3) **Family Limited Partnerships** - FLPs in their day were quite popular for asset protection, tax reduction, and control preservation. However, they are generally not as flexible as LLCs and can be more complicated to operate. General partners control the venture while limited partners have no control. The law denies the creditor the right to take any interest in the partnership, and if structured properly they can provide great anonymity, again with little governmental oversight when there is no fraud or abuse.

4) **Offshore Entities and Banking** - Who hasn’t read stories or heard about Swiss bank accounts and Grand Cayman Island entities? By creating offshore entities, organizers can achieve high levels of privacy and potential asset protection. Potential claimants have trouble going after these assets when they can’t find them. U.S. Courts cannot always reach the assets when located in countries that do not have mutual recognition treaties with our country. There are significant costs involved in these arrangements, and sometimes they carry significant amounts of suspicion when people find out about them. The federal government has taken steps in recent years to reduce actual and perceived abuses as some companies use these entities for tax schemes and other fraudulent purposes.

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