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# Introduction to Asset Protection

## Diversified Real Estate Investor Group

### Real Estate 101

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## 1. GENERALLY, WHY USE AN ENTITY?

- a. Liability/Asset Protection—“keeping our stuff”
- b. Transferability of interests—easy to transfer a share of company stock
- c. Layering and Segregation—keeping assets separate—with different “people” keeps them safer—limits your losses
- d. Some degree of privacy—you can be the “manager”, not the owner
  - i. The motivated can still find out who the real owner is

## 2. GENERALLY, WHY NOT USE AN ENTITY?

- a. Cost—cost to set up, cost to file with state, cost for fictitious name
- b. Complexity/Administration—some are pretty straightforward, but there is still some recordkeeping—bank accounts, TINs, etc. Got to keep them separate!
- c. Capital Stock and other State/Federal taxes—some are going away, but still there—need to TALK TO YOUR ACCOUNTANT
- d. Higher borrowing costs/Lower LTVs
- e. Marital status—ways to partially shelter using JT TEN WROS, TEN IN COMM, etc.
- f. Depends on your RE investing GOALS: Buy/hold, flip, lease option, other?

## 3. ALTERNATIVES?

- a. ROLL THE DICE - Don't get sued! Be very, very careful. Have perfect tenants....
- b. D/B/A - NO protection, just some privacy against lazy people looking for you
  - i. Ex: d/b/a Peyton Properties
- c. LOTS AND LOTS OF INSURANCE—Umbrella, good coverage—talk to your team—insurance guy or gal
  - i. SOMETIMES THE WAY TO GO—depends on your particular circumstances
    - 1. Assets
    - 2. Net worth
    - 3. Goals
    - 4. etc.

## INTRODUCTION TO PARTNERSHIPS

The General Partnership:

FACT SCENARIO:

Investment property - little run down, needs “updating”, great price due to death in family.

2 Friends for years: Joe is a carpenter with a wide skill set. Steve is an accountant, not so “handy”.

Idea: One brings the money, one does the work. They’ll split the profit down the middle. Let’s form a partnership! How could they lose?

Partnerships are:

- Quick, easy, and inexpensive to establish
- Say it’s a “Partnership” and it is! Shake hands and you’re done.
  - No agreement, no filings, no licensing, no attorney fees, no nothing!
    - Can slice and dice profits and losses as desired.
    - Easy to administer, flexible, easy to dissolve. No double taxation.
    - Can also file a Fictitious Name registration and draft a partnership agreement to be fancy.
    - Taxed at individual tax rates. Fed. Tax Form is a 1065. State tax form is an informational return only -PA 65.
    - GOOD IDEA?
      - **NO!**
  - Draw backs:
    - *Absolutely no asset protection!*
      - Actually increase your liabilities because you are liable for anything your partner does—whether you want him to or not!
      - Partnerships must dissolve upon death or resignation of a partner, but you can elect to reform
    - Without a partnership agreement, spelling out the rights, duties and obligations of the parties, what happens with:
      - Divorce? Death? Unequal contributions of time or money? Etc, etc, etc.
        - HEADACHES! DESTROYED FRIENDSHIPS!

**Q: Do I like General Partnerships?**

A: No! With the advent of the limited liability company, there is little reason or benefit to using a general partnership. "Cover your assets" and use an LLC or a limited partnership.

## A Different Kind of Partnership

The Limited Partnership-more like a corporation or an LLC

- More onerous and expensive to establish and administer
  - What is involved in Setting Up /Administering a Limited Partnership?
  - Must incorporate or form a limited liability company (LLC) to serve as the “general partner” (generally having only 1-5% ownership).
    - The General Partner – Has full control. Full responsibility for management.
    - Also has unlimited liability
  - Remainder of the ownership interests (the partners) are in the form of “limited partner” interests, which are generally owned by individuals.
    - The Limited Partners
      - No control.
      - No responsibility for management.
      - No personal liability.
      - Can only lose up to his/her initial investment (with some exceptions).
    - The Limited Partnership is established by filing a "Certificate of Limited Partnership" with the state.
    - Then create the Limited Partnership Agreement among the partners
      - Who gets what?
      - Who is responsible for what?
    - Issue Certificates of Limited Partner interest
    - Create accounts: 2 sets of books, records, tax returns, financial statements
      - one for corporate/LLC general partner
      - one for the limited partnership
    - Must be very careful when entering into contracts and how you sign documents
    - Access to mortgage loans will become more limited
    - Documentation of transactions will become more complicated—resolutions, limited partnership agreements,

So, it's a bit of a pain. Then what are the benefits of setting up a limited partnership?

- Usually Serves as Two Entities in One
  - The general partner (who has unlimited liability—can lose ALL his/its assets) is usually a corporation or LLC.
  - The limited partners, usually individuals (as long as they are truly passive investors) are protected from the liabilities of the partnership and can lose only up to their initial investment—the buck stops there.
- Raising Capital- The L.P. is a readily accepted entity for raising investor capital
- Well established entity -Plenty of case law
- Plenty of accounting and tax knowledge
- Taxation - Most of profits are taxed at individual rates
- Avoid Double Taxation -No double taxation of distributions or double taxation of capital gains. Income is distributed pro-rata by the "K-1" schedule to the partners.
- Flexible allocation of benefits. You may allocate profits and losses between the limited and general partner.
  - For example -the general partner, lower tax bracket, needs income -give management fees and cashflows. The limited partners, higher tax bracket, needs appreciation and tax write-offs
- Corporate Fringe Benefits -Derived from the Corp. General Partner
- Potentially stronger, 2-level firewall

\*In most states the LLC has all of the benefits of the L.P. without the hassle and baggage of maintaining two entities, two tax returns, corporate formalities, etc.

Sounds great, right? Yes, but:

*THERE MAY BE TAX IMPLICATIONS that make the LP the better choice for YOUR circumstances—See your accountant!*

To date, in PA, the larger real estate operators regularly use limited partnerships due to the state tax situation in PA—but this is changing as the capital stock tax fades away to nothing over the next couple of years. Nonetheless, if you plan to accumulate a large portfolio of rental properties -and plan to be in real estate for a while –one of your options should be the limited partnership.

## INTRODUCTION TO LLCs

### 1) What is an LLC?

Limited Liability Company --The Limited Liability Company is a hybrid. A kind of general partnership in structure and style of management with the general partners having limited personal liability. Or a limited partnership where the limited partners have management rights. Management and tax benefits of a partnership, liability protection of a corporation, with no need for the formalities of a corporation.

The best of all worlds? Maybe—offers lots of protection if done right with relatively little effort.

### 2) Benefits of an LLC

- Full personal liability protection for owners and managers
- Financial privacy
- A separate legal entity -different from owners.
- Quick, cheap, and easy to set-up.
- Few corporate formalities.
- Asset protection benefits of a limited partnership or corporation
- Owners may be any legal entity (even other corporations or LLCs) or foreigners, unlimited # of owners
- Flexibility in allocation of profits and losses -not necessarily pro-rata.
- Taxes -may file its own return, or not (only if single person).
- Tax year selection -Calendar or Fiscal (usually calendar).
- May elect to be taxed as either a partnership or a corp. "check the box" No double taxation of dividends.
  - Can be a "disregarded entity"—the profit and losses "pass through" to your personal returns

### 3) Drawbacks of an LLC

- Used to be a new type of entity with little case law to guide courts—not anymore.
- Limits the type of real estate financing available
- Higher borrowing costs
- Lower LTVs
- Extra bookkeeping/accounting—although minimal
- Some "corporate formalities"—relatively minimal, though; limited to "major" events like borrowing money, buying property, etc.

### 4) What is Needed to Set Up an LLC?

- Name availability (consider whether you'll want web address and/or Trademark also—important!)
- Filing of Certificate of Organization (in some State called the Articles of Organization)
- Certificates of Ownership –optional
- Company Seal- optional
- Payment of Fee to state

**Q:** Should you stop there? NO. Not if you want the LLC to protect you!

- Operating Agreement -similar to a partnership agreement.
  - It is the “rulebook” for how your company will run—more detail coming
- Fictitious name considerations—LLC name (Smith’s LLC) vs. “Smith’s Candies”
  - Availability—must be checked, permission obtained or new name chosen if taken
  - Web Site/Trademark considerations
    - Want the website to have the same name as company, right? Must be checked
    - Trademark—can be infringing on TM even if name is available in the state-bad news!
- Probably need SS-4 Form -Request for Employer Identification # (EIN)—Banks want them to set up accounts
- Tax Forms -Federal- Usually a Partnership 1065 Form or a Corp. 1120 Form
- Tax Forms -State -PA 65 (Partnership Return)

#### 5) What is a "Member" of an LLC?

- A Member is an owner of an interests in an LLC (membership interests)
- The member has the rights to income and loss distributions on a pro-rata basis or as is specified within the Operating Agreement
- The member has rights to participate in the management of the company as specified in the Certificate of Organization and/or the Operating Agreement
  - In lieu of using the title "member", the LLC may elect to adopt corporate titles such as President, Vice President, Secretary, & Treasurer
- Can separate out “ownership” interests from “voting interests”—can be important for control purposes with multi-member LLCs
- Can be “Managing Members” and “Non-Managing” Members
  - Like General and Limited Partners
- Liability -Neither members nor managers are personally liable for the debts, obligations or other liabilities or torts of the company solely by reason of being or acting as members or managers. Failure of the LLC to observe corporate formalities is not necessarily grounds for imputing personal liability to the members or managers.

#### 6) Member Managed vs. Manager Managed

- Member Managed - In a member managed LLC, the owners, or members manage the company like general partners in a general partnership.
  - Each has a vote in proportion to his/her % membership interests. All the owners more or less act as part of the Board of Directors or "Board of Members"
- Manager Managed. One or two Members are designated in the Operating Agreement as "active" or "Managing Members", the others are designated as "passive" or "Non- Managing Members"
  - Management Authority. Primarily by virtue of the Operating Agreement, but may also be referenced in the Certificate of Organization.

#### 7) What is the Operating Agreement?

- Similar to a partnership agreement

- Items to consider/What is included?
  - Name of the LLC
  - Owners' names, addresses, % ownership and capital contributed
  - Voting Rights
  - Owners' management responsibility, authority and compensation
  - Disputes—Major and Minor-what happens?
  - Ownership "Buy/Sell" Agreement
    - Valuation method used for "Buy/Sell".
  - Methods of accounting. (Generally cash basis on a calendar year.)
  - Transfer of ownership and limitations thereon. (Rights of first refusal?)
  - Allocation of profits and losses.
  - Permitted and prohibited transactions (outside interests)
  - Business goals and objectives and line of business.
  - Selection of Bank, Accountant, Attorney.
  - Active vs. Passive Members -(Note Self-employment tax, pension implications).

## 8) Taxation of LLCs

- Single Person LLC -Can have or not have its own return/EIN #
  - Federal- "Check the Box" -default is as a partnership, but may elect taxation as a corporation
  - State -most states tax as a partnership

## 9) Self-Employment Taxes and LLC's.

- In general the distributive share of earnings from an LLC are subject to self-employment taxes. Taxes paid by the member being allocated the earnings.
- "Guaranteed Payments". Term for compensation for services paid to a member within an LLC; Guaranteed payments are subject to self-employment tax
- Election of "Active vs. Passive" in Operating Agreement. Managing members vs. non-managing
  - May be able to avoid self-employment tax based on situation.
- Nature of Income
  - Interest, Dividends, Rents –are passive, therefore, may not be subject to self-employment tax

## 10) Distribution of Earnings in an LLC

- In a Corporation -Pro-rata distributions based on share ownership.
- In an LLC -The parties agree to slice and dice it (as defined in the Operating Agreement)
  - Implications for high and low tax bracket members. (i.e., High tax bracket investors get more basis in the LLC (growth), low tax bracket investors get distributions of taxable earnings.
- "In-Kind" Distributions -In a corp. deemed as a sale, therefore subject to capital gains. In an LLC -not deemed as sales, therefore, no capital gains, the person receiving the distribution gets property at the LLC's cost basis.

## 11) Writing off of Losses in an LLC

- Subject to “at risk” limitations.
  - In general, you can only take losses up to your basis in the LLC, plus the value of recourse debt. Once your basis is written down to zero, losses are suspended and “carried forward” until the LLC has more earnings or is liquidated.
  - Generally -if you have passive losses -try to offset with passive income. If you have active losses, try to offset with active income. SEE YOUR ACCOUNTANT!

## 12) Withdrawal of Members

- Upon the death or withdrawal of a member, the LLC may or may not be dissolved
  - See the Operating Agreement
  - The surviving members may elect to continue the LLC
    - Operating Agreement will spell out what happens—who gets paid what

## 13) Estate Planning Issues

- Gifting of minority interests to family members.

## 14) Potential Uses for the LLC

- In lieu of a sole proprietorship
- Especially In lieu of a general partnership.
- For buy, fix and flip deals.
- To separate out “deal status” from your other properties
- As a management company
- As a general contracting company
- As a general partner in a limited partnership
- As an entity in a “multi-layered” transaction
- CIRCUMSTANCES MAY VARY—SEE YOUR LAWYER AND YOUR ACCOUNTANT

## 15.) Introduction to LLC Layering Strategies

- A limited partnership owns the property
  - General partner is a corporation with the individual investor (or another LLC) as the limited (1%) partner.
- L.P. master leases to an LLC.
- LLC deals with the tenant on a “sublet” basis
  - LLC is contractually responsible for all maintenance, repairs, everything related to the property.
- LLC holds few if any assets.
- Insulation of the property and the individual owner from most if not all liability.
  - Individual investor is 2 or 3 layers removed from any tenant related liability -protected by the LLC and the L.P.

## INTRODUCTION TO CORPORATIONS

### 1.) What is a Corporation?

- Like an LLC in that it is a separate entity
- A corporation is a form of organization for business purposes
- Legally, it is an "artificial person" of sorts formed by one or more individuals for conducting a business enterprise.

\*A little history: It is a separate legal entity, created by law. The corporation dates back to 14th century English common law and has been a part of American business since the founding of America.

Corporations were established to raise money for the exploration and settlement of colonial America. For example, in 1629 the Massachusetts Bay Company (which founded Boston) was chartered by Charles I of England to colonize Massachusetts. The Hudson Bay Company of Canada was founded in 1670 -and is still in existence today. In the early 1800's New York State first drafted legislation permitting incorporation in the state. By 1900, nearly all other states had incorporation statutes.

### 2.) Benefits of Incorporation.

- Limited liability for officers, directors and shareholders.
- A separate legal entity from its owners -asset protection; A corporation can do almost anything a person can do.
- Lower taxes than personal rates -up to \$150,000 in AGI. .Shares can be easily sold to raise capital.
- Perpetual existence permits the business to continue after a shareholder's death
- Easy sale, or transfer of share ownership.
- Shares can be gifted or transferred as part of an estate plan
- Profits and losses are allocated on a pro-rata basis.
- Many fringe benefits are available -pension plans, health insurance, 129 cafeteria plans, expense reimbursements, etc.
- Tax Planning -use of fiscal year accounting vs. calendar year.
- Tax Sheltering -income in "c" corporation taxed at corporate level- not personally
- Domicile of corporation in a low tax state.

### 3.) Drawbacks of Incorporation.

- Cost of Incorporation
- Must file annual state and federal tax returns.
- Must keep separate books, accounts, & records.
- Must follow corporate formalities -meetings, minutes, resolutions, officers, board of directors, annual state filings, etc. -this can be critical to keeping protection of corporation "firewall"
- Double taxation of dividends.
- Double taxation of appreciated property at time of liquidation -capital gains within the corp. and taxation of dividends upon distribution.
- Complicated tax rules -both state and federal.
- Real estate financing becomes more limited for small investors.

## What's Involved in Setting up a Corporation?

### 4.) Naming the Corporation

- Names can convey -big, small, rich & poor. Large corp. or mom and pop. .Examples -The Prudential. Ben & Jerry's.
- Pick two or three names in preference order and call the Dept. of State for name availability. Be creative.

### 5.) Submitting Articles of Incorporation to State

What is in the Articles of Incorporation?

- Name of the Corporation.
- Corporation's primary address. .Principal business activity.
- Number of shares authorized for issuance. Par value of shares.
- Voting rights attributed to shares
- Statement that the directors are not personally liable
- Statement that the officers are not personally liable.
- Name and address of the incorporator (usually your attorney)

### 6.) Advertisement Requirement

- Both legal publication & general circulation newspaper. Corporate binder should have proof of publication signed by the publishing company and notarized.

### 7.) Written Consent of the Incorporator

- The incorporator (usually your attorney), names initial directors, and adopts initial bylaws, calls initial Directors together for Organization Meeting.

### 8.) Organizational Meeting, or Unanimous Consent of Directors ~ Lieu of Organizational Meeting

Resolutions are passed where corporation decides on and approves the following:

- Approval of filing the Articles of Incorporation
- Approval of acts of Incorporator.
- Acceptance and ratification of bylaws
- Adoption of corporate seal.
- Approval for initial share issuance and share price to shareholders.
- Adoption of share certificates to be used by the corporation
- Election of initial officers.
- Approval of Bank, Accountant, Attorney, etc.
- Adoption of fiscal or calendar accounting/tax year
- Adoption of "c" vs. "s" election (summarily: be tax-treated as corporation or pass-through basis)
- Authorization for officers to conduct the business of corp.

### 9.) Shareholder's Agreement

- Not required but strongly recommended
- Restrictions on stock transfer/ownership.
- Restrictions on pledge of stock as collateral.
- Buy/Sell Agreements between owners. Funded by life insurance?
- Valuation methods of stock under Buy/Sell Agreements.
- Rights of first refusal in event of death, withdrawal or involuntary transfer
- Options and rights to options on shares
- Limitations on corporate actions.
- Limitations on permitted business activity. Disallowed transactions.
- Shareholder approval for certain transactions (i.e. instead of decision by officers and/or directors). Usually “major” items only.

### 10.) Corporate Bylaws-The Rule Book

Contains:

- Shareholder Meetings. Place, time, notices, organization voting
- Directors-number of, term in office, resignation, meetings, compensation
- Officers. Same as directors above.
- Limitations on Liability -Directors and Officers/Indemnification of Directors and Officers/Officers and Directors Insurance.
- Expense Reimbursement Policies.
- Stock Certificates and Transfer of Certificates/Financial Reporting Requirements
- Amendments to Bylaws
- Resolutions
- Minutes

### 11.) Who Controls the Corporation?

- Shareholders (the owners) elect Board of Directors who appoint/approve Officers who hire Employees

### 12.) Annual Shareholders Meeting

Why?

Main purpose -election of Directors. Minutes.

### 13.) Annual Director's Meeting

Why?

Main purpose -election of Officers. Minutes.

### 14.) Resolutions

Required for major transactions, new initiatives, loans, purchase of assets like real estate, etc.

### 15.) Stock Certificates –evidence of ownership of part of corporation

16.) Stock Transfer Ledger- keeps track of who owns what

17.) "Piercing the Corporate Veil."

A phrase you never want to hear!

- A breach of the firewall you've created—very bad news
- If corporate formalities are not followed, owners, officers, directors may be sued personally
  - If you do not always act like a corporation, the courts will not treat you like a corporation and can lose all protection

18.) Fringe Benefits Available Within Corporation

- De Minimis Fringe Benefits are tax free -Examples -newspaper, magazines, coffee, donuts, meals, entertainment, travel, lodging, sports tickets, photo copies, etc. Some Examples:
  - Corporation can expense up to \$5,250/year for employee education, without any taxation of benefit to employee (Implication for college age kids.)
  - Medical reimbursement, health club reimbursement, dental care, reimbursement for child care, and elderly dependents.
  - Loans to Officers. With limitations. Careful. May be deemed as a dividend (and double taxed) if not done properly. Document, modest but some interest rate, payment terms, etc.

19.) The "C" Corp. vs. "S" Corp. Election. Which is better for you?

- I don't know! Talk to your accountant—personalized choice appropriate for YOUR circumstances.

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***So, which entity is best for you, Mr. Real Estate Investor?***

The best lawyer answer: "IT DEPENDS" Depends on your goals, your personal resources and net worth, etc.

\*Talk to your team: Attorney, accountant/tax adviser, insurance broker, etc. A coordinated approach to what you want to do, how you intend to get there, and how best to minimize risk is essential!