LAND TRUSTS

EFFECTIVE TOOLS FOR AVOIDANCE OF PERSONAL LIABILITY AND ASSET PROTECTION IN HOLDING TITLE TO INVESTMENT REAL PROPERTY

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Significant wealth preservation planning objectives can be achieved by holding title to investment real property in a specific type of trust known as a "land trust," a.k.a. "Illinois land trust" or "title holding trust." These objectives include:

- Avoidance of personal liability – Avoidance of personal exposure to risks associated with ownership and control of property through titling in a properly structured trust, entity or combination thereof (a.k.a. containment of risk).
- Asset Protection – The protection of an investor's assets against the investor's potential personal creditors and liens (i.e., charging order protection and the avoidance of attachment of liens).
- Compartmentalization of Liability; Segregation of Wealth – The division of working assets into separate structures and separation or "stripping" of equity from the assets.
- Privacy – The avoidance of public disclosure of ownership for the purpose of discouraging lawsuits.

In many instances, a land trust in conjunction with a limited-liability company (LLC) offers the most efficient means of achieving these wealth preservation planning objectives.

WHAT IS A LAND TRUST?

Simply stated, a land trust is form of land-ownership arrangement by which a trustee holds title to land while the beneficiary retains the power to direct the trustee, to manage the property, and to enjoy the income from the property. For income tax purposes, like an LLC, it can be structured so that the investor enjoys all of the tax deductions personally.

Part I of this article provides an overview of these four wealth planning objectives. Part II provides a few examples of how these objectives can be achieved by holding title in a land trust, an LLC, or a combination of these two structures, and offers a comparison of the techniques.

PART I - OVERVIEW OF WEALTH PRESERVATION PLANNING OBJECTIVES

Avoidance of Personal Liability. Probably the most important wealth preservation planning objective for most real estate investors is the limitation of personal liability on the part of the investor for liabilities occurring in relation to ownership and operation of the property.

Liability stemming from the ownership and operation of real property can arise from several sources, including:

- Contract
- Tort theory
- Statute

Proper structuring with an LLC or land trust, or a combination or these planning instruments, can reduce an investor's risk of personal liability in all three areas.

Contract Liability – Contract liability can be limited to a degree through proper trust or entity structuring. While most recourse lenders may require either the investor's personal guarantee or that the investor take title personally as a condition of making a loan, many vendors and service providers will agree to limit their dealing with the entity. To that extent, personal liability for contractual obligations of the trustee or LLC can be avoided. Caveat: Contract liability will only be avoided when the manager or trustee deals with others in his or her representative capacity. It is especially critical that all written material identify the entity or trust, and that all signatures identify the signor's representative capacity.

Tort liability (Premises Liability) – Without a doubt, the greatest liability risk for most real estate investors is the risk of being held personally liable for injuries which occur upon or in conjunction with the operation of real property, known as Premises Liability. Premises liability is generally based on three factors; ownership, possession, and control. Fortunately, much of this risk can be avoided through the use of proper trust and entity structuring. The general rule is that neither members nor managers of an LLC are personally liable for the debts or obligations of the LLC by reason of such positions alone. The same rule applies generally to trustees and beneficiaries of a trust.

Ownership. A member of an LLC is not deemed to own the underlying property owned by the LLC. Similarly, beneficiaries of certain trusts are not deemed to own the property held by the trust. This means that, to the extent liability is based upon ownership, so long as the investor's property is held in trust or in an LLC, and assuming the structure is respected by the courts, no liability should flow through to the investor personally.

Control. As a general rule, a trustee or LLC manager can be held liable only in his or her representative capacity, and not personally, for the liabilities of the LLC or incurred in connection with the operation of the trust. However, there is an exception to this general rule: Managers and trustees will be held personally liable for their own misconduct. For instance, if a manager of an LLC should decide to replace a broken water heater himself rather than hire a licensed plumber, and the water heater explodes causing injury as a result of his own personal negligence, he cannot avoid liability on the basis that he was merely acting on behalf of the LLC. In this instance, the actor was also acting as an agent of the LLC, as well as its manager. The foregoing is an example of active negligence. Premises liability based on control can also result from passive negligence (failing to act where one has a duty to act). Generally, the duty to act falls upon the owner unless otherwise delegated. Personal liability for passive negligence can be avoided through proper LLC or trust planning, by limiting who has a duty to act.

Possession. In many cases the owner of investment real property maintains some degree of possession over the property, especially in the case of multi-residential properties. For example, the owner may maintain possession over common areas such as sidewalks, and will be deemed to be in both possession and control for purposes of establishing liability. Again, by placing ownership within a properly structured LLC or trust, personal liability can be avoided, to the extent it is based upon possession.

Statutory Liability – Certain liability can be imposed on the basis of ownership alone, without regard to other factors. One example is environmental liability under the federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 USC §9601 et. seq. Proper trust or entity structuring can avoid this liability being imposed on the investor.

Asset Protection. Asset protection is a term used to describe planning for the protection of an investor's assets or, more accurately, an investor's wealth, from the investor's own personal creditors or future creditors. This type of planning usually involves the investor's relinquishing ownership or control, or both ownership and control of assets, or better yet, avoiding direct ownership or control in the first place.

Charging Order Protection – One of the most common methods used to thwart creditors, at least temporarily, involves divesting control of assets by placing them in a partnership, or by creating a partnership interest in specific assets. Courts are reluctant to force a partnership between one person and his or her partner's personal creditors. Therefore, the most a partner's creditor will typically expect to obtain over partnership assets is a lien against the debtor's partnership interest called a charging order. Depending on which state's law applies, the creditor will often have to await the partnership's decision to make a distribution of partnership assets or profits before realizing anything. Some states have even passed legislation purporting to afford charging order protection for assets held in a single-member LLC.

Recent cases have placed restrictions on the availability of charging order protection, not only in the context of a single-member LLC, but in the context of a partnership as well. The good news is that these cases provide a roadmap for planners to use in structuring trusts and LLC's to overcome these restrictions. In many cases, a land trust used in conjunction with an LLC properly structured for charging order protection, provides a superior two-tier protection.

Avoidance of Attachment of Liens – An important traditional benefit of a land trust is the avoidance of the attachment of personal liens of one or more trust beneficiary to property held by the trust. Like LLC's, while trusts are often used in the context of multi-owned property, they can be used effectively with a single beneficiary as well for this purpose.

A discussion of more aggressive asset protection planning involving trusts is beyond the scope of this article.

Compartmentalization of Liability; Segregation of Wealth. Compartmentalization of liability results from holding several assets or properties apart from one another. Use of a separate land trust to hold each property, with an LLC as the common beneficiary of each trust, can be a cost-effective way to prevent premises liability from attaching to the investor personally or to the other properties. Segregation of wealth describes the holding or separating of the equity in a property from the ownership of the property itself. The process of separating equity from the property itself is also sometimes known as equity splitting. The use of multiple land trusts can be an economical method to achieve this result.

Privacy. Many people desire privacy for a number of reasons. Privacy planning associated with wealth preservation can be summarized into three categories: (1) avoidance of public disclosure of a particular property's owner; (2) avoidance of public disclosure of a particular owner's property; and (3) avoidance of public disclosure of properties under common ownership – that is, the appearance of wealth. The common goal is to discouraging lawsuits. Proper use of a land trust can provide important additional privacy protection.

Part II – Examples of Uses of Land Trusts; Comparison with LLC

Following are a few examples of how the above wealth preservation objectives can be achieved by the use of a land trust, an LLC, or a combination of both.

Scenario 1: Nevada Resident Holds Investment Real Property In Nevada And In California.

Nevada Property in Series LLC

The investor's Nevada property would typically be held in a Nevada LLC, preferably a Nevada "Series" LLC,[1] or, if added privacy protection or protection against the attachment of personal liens is desired, each property could be held in a separate land trust each assigning beneficial interest to a series of the LLC.

Use of LLC to Hold the California Property

With respect to the California investment property, the investor would typically hold all property in a single LLC, or if compartmentalization of liability is desired between multiple properties, in an LLC for each property. Alternatively, the property could be held in a second Nevada LLC (or second series of the investor's Nevada Series LLC). The LLC or each series would have to be registered with the California Secretary of State to "do business" in California.[2] Failure to register the LLC could have severe adverse consequences.[3] In addition, the investor would need to appoint a California registered agent for service of process within California for each LLC. At the county level, the recorded deed conveying the real property to the LLC will name the LLC as grantee, but will not name its managers or members.

[1] Nevada is one of seven states which has enacted legislation allowing for the creation of a "series" LLC, thereby allowing for the limitation or "compartmentalization" of liability between separate "series" within a single LLC; in essence allowing for the creation of multiple limited-liability structures with one filing requirement.

[2] The California Franchise tax board has taken the position that the holding and operating of California investment property constitutes "doing business" within the state, and because California law does not recognize a "series" LLC, that each series which owns property within California must be registered.

[3] First, in order to obtain title insurance at time of sale or refinance, the LLC will most likely have to be registered and back registration fees and penalties will have to be paid. Second, there is a theoretical risk that the LLC will be more likely disregarded by a court of law if it is unregistered.

Use of Land Trust(s) to Hold the California Property with LLC as Trust Beneficiary

An alternative approach that could have significant economic benefit to the investor would be to hold legal title to each California property in a separate land trust, with the Nevada LLC as trust beneficiary. Unlike an LLC, a land trust is not considered to be a distinct legal entity.[4] Therefore, the trust is not required to be registered with the California Secretary of State, and does not pay a franchise tax. At the county level, because the trust is not a separate entity, the recorded deed conveying the real property into trust will name the trustee and his/her/its capacity (e.g., "Jimmy Jones, as trustee under that certain trust agreement dated . . ."). The trustee may be a friend, attorney, advisor, etc., or even a corporation or LLC managed by the investor, and need not even be a California resident or entity domiciled in California. Another benefit to the investor is that the Deed in Trust can be structured to greatly limit the trustee's ability to affect title by him or herself.

If the plan involves multiple California properties, one approach the investor may want to consider would be to assign the beneficial interest in each trust to a separate series of the Nevada LLC. This way, compartmentalization of liability can be maintained even if for some reason the trust should be revoked or disregarded.[5] As long as the beneficiary need not register to do business in California, this can result in substantial savings.

"Doing Business" in California

Under a typical trust arrangement, responsibility for the management of the trust property is reserved to the trust beneficiary. If the investor designates his or her Nevada LLC (or an LLC series) as beneficiary, the California Franchise Tax Board may take the position that the LLC (or each series) must register to do business in California, at least if it actively manages property in California,[6] although failure to do so will probably not affect title to the trustee's ability to transfer clear title at a later date.[7] One way to counter this argument would be to create a separate "management series" which could be assigned all management responsibilities under each trust, and could hold a fractional beneficial interest of each trust.

Transfer Tax and Property Tax

A significant consideration when transferring property owned by an investor into an LLC or trust is the issue of documentary transfer taxes and reassessment for purposes of ad valorem property taxes. Each state has its own exclusions for certain transfers. California excludes certain transfers in trust and into and out of an LLC, assuming the transfer does not result in a change of ownership.[8] The use of either an LLC or land trusts should avoid unnecessary taxation on transfer in either direction.

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[4] While a "business trust" is considered to be an entity for registration and franchise tax purposes, a properly structured land trust is arguably not a "business trust" since all management function is reserved in the trust beneficiaries.

[5] Under a land trust arrangement, the right to revoke remains with the holder of the beneficial interest.

[6] Although, since the LLC is only a trust beneficiary and will not appear on any public land record, profits or losses from rental activities which flow through to the LLC must be reported for income tax purposes. Even if the LLC conducts all of its management from outside of California and hires a property manager to handle operations within California, the investor must presume that the California Franchise Tax Board will become aware of its involvement and demand payment of tax and possibly penalties for a failure to register.

[7] An argument could be made that, so long as the beneficiary LLC employs a licensed California property manager, and the beneficiary LLC's managerial activities are conducted wholly outside of California, the LLC may actively participate in the management of the property for income tax purposes, yet not be deemed to do business in California as to trigger the registration requirement.

[8] Because California transfer tax is applied at the county level, the transfer tax may not be imposed uniformly throughout all California counties.

Several states (for instance Nevada) exempt certain transfers of property to and LLC but not from an LLC. Therefore, if the investor anticipates that the need might arise to convey property temporarily from the LLC at a later date, for instance for refinancing, a trust may be more cost effective depending upon the particular state's exemption law. The laws of the locale in which the property is situated should always be considered before selecting the method of holding.

PRIVACY

LLC – When title is taken directly into an LLC, other than the name of the grantor, the recorded deed will contain only the name of the entity. However, public filings with the Secretary of State will contain the name of each LLC manager (or, if the LLC is member-managed, the name of each member-manager!). A quick computer search of the Secretary of State's website combined with an ownership or title search at the county level (which often is available online or can be gotten at little expense through a number of commercial services) will reveal all entities having the same managers or member-managers, as well as all properties owned by those entities. Because the manager of an LLC has a great degree of control over the underlying property, in almost all cases the investor will want to name him or herself as a manager of the LLC, and thus appear on the public record.

Land Trust – When title is taken in a land trust, the only name appearing on the public record other than the grantor will be that of the trustee. The identity of the trust beneficiary or beneficiaries is not disclosed on the deed, and ordinarily should be discoverable only by access to the private trust agreement (kept by the trustee and beneficiary), tax records,[9] if intentionally disclosed by the investor in an application, etc., or by subpoenaed deposition of any person with such knowledge. If property is acquired directly into the trust (the preferred but not always available method), rather than first by the investor personally, the investor's name would appear nowhere on the public land record associated with the property.

There is another reason public access to ownership information may be more difficult by holding property in a land trust rather than directly by an LLC. An LLC, whether domestic or foreign, has to maintain records within California, including personal information about all LLC members. The same rule does not apply in the case of property held in trust. Further, by selecting a trustee who resides outside of the state where the property is located, a potential plaintiff may be deterred from filing a lawsuit by the additional expense involved in gaining discovery from an out-of-state defendant. Of course, in the case of a severe injury, a lawsuit will likely be instituted regardless of these initial privacy roadblocks. That is why privacy protection should be considered only an initial deterrent. Nevertheless, the use of a land trust has some additional privacy protections over titling property directly into an LLC.

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[9] Generally, the investor will desire the tax benefits of active ownership. As a result, both federal and California tax returns will reflect the investor as the property's active owner.

Limitation of Liability and Asset Protection

The same liability protections afforded an LLC apply generally to a land trust. In both cases the beneficial owner should not be deemed to be the owner of the underlying real property, and generally is not personally liable for obligations arising from ownership of the property. Also, neither the LLC manager nor the trustee by reason of that position alone should have any personal responsibility for tort liabilities or other obligations of the LLC. Both structures also enjoy similar asset protection features such as charging order protection and avoidance of attachment of personal liens. A combination land trust/LLC structure provides superior protection, and often at a reduced cost where the plan involves multiple properties.

Fraudulent transfers

A transfer of property already owned by the investor for less than its full value can trigger a fraudulent transfer if the transfer leaves the investor with insufficient resources to meet current or anticipated liabilities. A transfer in trust or to the investor's LLC is not excepted from this rule. This is one reason why title should be taken directly from the seller into the investor's trust or LLC, if at all possible, and why any transfer of title currently held by the investor should be transferred into an LLC or in trust as soon as possible, to start the period of limitations running on the transfer.

Conclusion

For the Nevada investor holding California investment real property, an efficient means of achieving the four identified planning objectives is to create a separate land trust for each property naming a separate series of a Nevada Series LLC as the beneficiary of each trust, and a separate management series or separate management trust, to handle the management of the properties.