SETTING UP BUSINESS SYSTEM STRUCTURES

Host: Zack Childress

So, the big question is this, how do aspiring real estate investors like us escape from the rat race and build real wealth and freedom without access to millions of dollars in investment capital and start to live the life that we know we deserve? This is the question and this podcast will give you the answer. My name is Zack Childress and welcome to Real Estate Investing Talk Show.

I want you to understand structure, right? What is structure? Structuring of a business is how do we position ourselves in a marketplace full of predators that want to do nothing but sue you for something for free, right? It is the world we live in, especially if you're on here and you are living in California. California probably has the most lawsuits filed in any other state out there. I could not move out of California fast enough to be honest with you. I loved California. I loved everything about it. I love the weather. I lived in the Bay Area off by the Carquinez Strait. I'm a little place called Benicia and Vallejo over there. I'm 72-degree weather all year long. It was perfect for me because I'm not a big fan of summer.

I love fall and I love spring. Somebody asked me the other day, what are your favorite seasons? My favorite seasons are fall, spring and Christmas. Yes. If you didn't know Christmas is a season (in my world). I was walking around today singing Christmas songs.

My favorite movie, and you butchered it.

I just love Christmas. I love everything about it. With that said, so you in California, you want to listen up. Listen, listen up to this. To stay safe guys, you got to start thinking about entity structure. You've got to start thinking about what am I exposed to when it comes to real estate and what are the different layers of exposure that I'm going to have to me. Now, I get asked, Zack, if I don't have an indie, can I go out and do real estate?

Well, of course you can. You can buy and sell real estate in your own name. But are there some repercussions to that? Absolutely. There's some repercussions. One is, if you're buying and selling real estate within 12 months and that deal makes a profit and you gained from what's called short term capital gains and you're gaining personally from it. Well, you might want to look into a little thing called real estate dealer taxation law, and that one, if you get hit with it can bite you really hard. Now before I keep going any further, I just need to let you guys know that I am not an attorney. I'm not a CPA. I'm not a doctor. I'm not a lawyer. I'm not an accountant. I'm not any of that. I'm a real estate boss and I'm not here to act like I'm giving you legal advice and you should seek your own legal advice at any time.

But I can absolutely tell you what I know to be true for my experience and what my legal team has shared with me in part of that is understanding exposure. And so, if you're doing it yourself and you don't have the right entity structure setup, you expose yourself. What that means is, one, what we were talking about, the dealer taxation law and the man it can get you. I had a friend down in Colorado who was investing for 10 years. Now, Joe, listen to this. Ten years he was investing, got hit by the IRS because he was doing it in an entity which he had that right? But his entity, he had it as an LLC which is setup as a pass-through profit. So, he was gaining profit for 10 years. IRS hit him as a real estate dealer because that's the taxation law that they can use and they retro activated for 10 years on him. Taxes, penalties, interest. Shut him out. Shut him out of business. Put him down, couldn't pay it. It was so much that it compounded over the years.

I wouldn't even know what I would do. I'd be calling you.

Well, he called me too and I said, they know you do. I mean you gotta pay it. I mean, you can put them on a payment plan. You can do what's called, I forget what the title of it is, but insolvent or something not insolvent. But you can go back and show like a hardship and I'm trying to get them to settle something with you or put a payment plan together. But even on a payment plan, I think they wanted him to put so much money down before they'd even do a payment plan with the rest.

But the problem with that is, most investors aren't really clear on that. So, they just run out and start chasing it without having the right structure in place. And look, here's what I've learned years ago, making money is easy. Once you understand how to change your mindset, to know that the world is an abundance of money and other people have your money, you just got to figure out how to get it back. It's everywhere. There's opportunities everywhere. I mean literally every moment you're in a clear state of focus, you will identify opportunities to make money.

So, making money's not the hard part, the two hard parts are taking the action to go after it and keeping it once you have it. Because let me tell you something, once you start making it, everybody wants it. I don't care if it's the IRS, if it's your Mama, your daddy, your brother, your sister, your neighbor, your cousin, your aunt, your niece. Yes, your kids, they all want it. Their tenants, your tenants. That's right. Your buyer, your seller, they all want it and they want it because they feel that you have it in. You probably have more of it than you need. And so, you should be giving them some of it too. And that's a hard lesson that I had to learn the hard way, is that you can only be nice for so long before people start taking advantage of it.

But one of the biggest people out there that sticks their hand in your pockets is the IRS and tenants, especially in land lording. And I'll explain why in a minute. So, I share that with you because you need to be aware of this. If you're not aware of this and you go down to your local CPA or local H&R block, they're not going to talk to you about this because they don't specialize in real estate investing.

You need to go to a real estate driven CPA firm that understands real estate accounting, understand real estate liability who understand real estate exposure and they can give you directions around this. Now, that takes me to the topic, which is the structure. When we're structuring for protection, we have to keep in mind all these outside sources. Are there all kinds of different ways to open up a business? Yeah, absolutely. You could open up an INC, incorporation, an S Corp, a C Corp. You could go open up an LLP, a limited liability partnership. You could go open up an LLC. What's the difference in them, right? Well, you know, a corporation, whether it be an S Corp or C Corp, they have benefits and they also have weaknesses, right? So like S Corps and C Corps aren't really designed to create limitations between the owner of the company and the company itself.

If you're an S Corp, well basically you are the S Corp. You are the company, you're just using the company for is they say tax shelter or tax structure advantages to have a company in place that you do in business through. The other thing is the C Corp. The C Corp allows us to create a company that is absolutely separate from us, meaning that it makes its own money, it pays its own taxes. It is an entity alone without us involved, even though we might own it and run it and manage it. But when you get into protection, you start moving more into like the LLPs and the LLCs. And so, what is an LLP? Well, before I get into that, let's go back to the corporation. So why is something called an S Corp and why is something called a C Corp?

Well, an S Corporation is just that - it is an asset, meaning that it's taxed as an S. It is designed to be a pass-through tax entity, which means is that you run that corporation all year and it makes $250,000, well you personally file taxes on the profits of that company, okay. What are the good of that taxation? Well, you filed taxes on it and you pay it once, right? What's the bad of that? Taxes. Well, if you're in a super high tax bracket already because you're making a salary off of that company and the profits from that business is just getting them to absorb it and put you in a different tax bracket. Then why would you do that? You would then create a C Corp or taxed as a C. Now, what's the good of a taxation C?

Well, it's just that it's not a pass through. It's a business that stands on its own. It's taxed on its own, therefore it doesn't ever show up on your end of the year tax filings. And so, you have your filings and let's say you want to capture yourself at $75,000 a year because you don't want to move into other tax brackets because your company's spinning off quarter million dollars a year in profit. Well, you have to weigh those odds out, right? Like, okay, if I stay at my salary at 75, I'm in this tax bracket. If I leave the company with its profits as a standalone, it's going to pay taxes on that. It's going to pay taxes as ordinary taxes of a company. It could be beneficial to separate those two.

But people will say, yeah, Zack, you got to pay double taxes if the company pays tax on it and then you pay yourself and you pay taxes on it.

Yeah, you would if you start pulling money out of it, right? Or you could expense it to another company for management purposes. In that way, it's an expense to one company revenue to another company. And that company could be a pass through. So, you're being taxed once on it, right? So, there's lots of ways that you could do it, you got to seek legal advice on that to make sure you're setting it up correctly. Right? And so, that takes us through the corporation structure.

Now let's move over to the LLPs. Now a lot of people I know like LLPs, but it's typically not because they are the sole owner of it. An LLP is simply limited liability partnerships. For an example, if me and you were to go into business together and you are going to be the managing partner, but I was coming in with a capital injection of say $100,000 and let's say I was entitled to 40 percent of that business.

The beauty of it is, me as a partner, I'm only liable to what I bring into the business. So, if I bring $100,000, I could lose that 100,000, but nothing more, unless obviously they break the valve and there's mismanagement of the company. There's lots of other reasons, but just for a standard operating, you know, a negligence or something of that nature or lawsuits if something was to happen, then as an LLP as a partner, I'm only liable for what I put in. Nothing more. And that's why you'll see in a lot of LLPs when there's multiple partners in the deal because they want the 40 or the 30 percent revenue from the business, but they don't want to be liable for anything else. And so that's one way to handle that.

Now, the other way that you might want to look at is an LLC, limited liability corporation. It is the same as a corporation, right? It has the same ability to be taxed as an S are taxed as a C. it's just limited liability, which means that as the owner, I have the limited liability in that LLC, which means it's standing alone, which means it creates a wall of protection between me and whomever is trying to come after that LLC as long as I'm operating it correctly. And that's the thing that most people don't understand. They open up an LLC and they think, oh, I'm protecting them in LLC. No, you're not. You've got to operate it correctly. You got to have yearly meetings. You've got to have recorded of minutes. You can't commingle funds. You got to have separate bank account, separate checking accounts. You can't pay one bill with the LLC with your personal money.

You start doing that and what happens is they can break the valve and say that you were using the company as a shelter and not as an actual company that you're really the one that's operating the revenue from it. And so, they go right to the LLC and a discovery period and they come right after you directly. So, if you have an LLC right now and you've had it for four or five years and you're like, oh my goodness, I haven't done any of that. It's okay. You go back and hold meetings. You said, okay, we'll have a meeting today. This will be my 2017. End of the year meetings, I'm gonna hold a meeting tomorrow. That would be my 2016. You can always go back and have those meetings and in all it is, is a document that you fill out that says, hey look, here's my updated minutes and meetings and here's what we talked about in here.

Listen, a meeting could be anything. It could be a meeting about what bank to pick to open your bank account. It could be a meeting about who you're going to use as your appraiser. It can be a meeting about which contractor that you're going to use. I mean, it's not that difficult to hold a meeting with yourself, right? And if there's other people in the entity, then you just have it with them. But you have to have those meetings. You have to be recording those meetings in your LLC binder. I'm keeping up with those documents. You have to do that and you have to make sure you don't co-mingle the funds to keep that LLC or any entity or structure in a good standing. The other side of it is, you got to make sure you stay in good standing with the state.

What do they call it here, Jill? They always ask us for when we go to close, do you remember that?

A certification of validation.

A certification of validation for companies that shows your company's real, which basically is just saying you got to pay the state money. And then they're like, yeah, he's real. So just another way for them to dip into your pocket.

So, let's move on over to the LLC. The LLC is probably the number one entity that people set up for protection. Now, what makes LLC so easy is they're just so common and everybody knows how to set them up. You know, people go down and they'll do them online. They'll go to the corporation company in dotcom and you can get them done for two or 300 bucks.

But when it deals with real estate's a little bit different guys, because we have so many things we have to think about in liability that we get exposed to in different things that we have to make sure in our LLC. One of the companies I've used forever, if you want to write this down, is Anderson Business Advisors. They're out of Seattle and Vegas. They're not the cheapest in the world, but 70 percent of their clientele is all real estate investors. They understand us. They understand dealer taxation law. They understand trust and how to build trust and what goes into a trust and the LLCs. I mean, when you don't have one in here, but when you get an LLC from them, it's like that thick man. I don't know if you guys can see that, but it is super, super thick because it covers everything.

So, LLCs have always been my direction. Now do I have other things I do, but let's talk about LLCs and their taxation. And why that's important is that when you open up an LLC, it's automatically taxed as an s corporation. Not an S, it's not an S Corp, but it's taxed as an S Corp because you gotta remember an LLC is a limited liability corporation. That's what it is. It's a limited liability corporation. It's automatically taxed as an S, which means it's a pass-through tax entity for you. Which means that if you're doing quick flips, you could be just like my friend in Colorado if they ever decided to come get you. I'm not saying they will, but here's the reality. It only takes one for them to flag you as a real estate dealer, which means then you get hit with the taxation law for being a dealer as a real estate.

How do you get away from that while you have to have an LLC and when you set it up or if it's already set up, you elected to be taxed as a C instead of an A. So, it's just a one-page document. If you already have it set up, you fill it out, you send it in, you re-elect it to be taxed as a C. If you're starting it out brand new, then you elect it to be taxed as a C. Now there again, that separates the profits from that LLC to you personally. Why is that important? Well, there again, study the real estate taxation. Study and understand the dealer classification and you'll understand why we do this. So, for me personally, I have an LLC that I set up for holds and it's elected as it is set up. It's an s taxation, which means that everything that comes from that LLC, it comes to me personally and I filed taxes on it.

But then I also have LLC setup that are taxed at C. So, when I'm flipping in it, I don't have to worry about that hitting me as a dealer. Another reason that I do it that way is because I want to keep my tax bracket at a certain level because only Lord knows I pay enough taxes. So, then I could like fund an entire under civilized island for what I've paid the IRS over years. I can buy an island and like build an army on it. So, the point with that is that I don't want to them him anymore but also want to keep myself safe. And so, if you want to do that, then that's really the ultimate structure.

I would tell people now, look, if you're starting to make a ton of money and you're starting to flip, you know, 40, 50, 60 houses a year, plus you're doing another 20, 30, 40 wholesale deals a year and you're starting to buy a lot of cashflow and you're starting to buy a lot of holds and things like that. Then what you need to understand is, you might want to start looking at other things. You might want to really get an advisor on your team. We really start digging in with maybe Anderson Business Advisors. They are legal business and tax advisory. I mean, that's what they are. They help with entities. They help with taxes. They help with everything. As you see it right there on the screen for you, that is their design. I'm not an affiliate of theirs or anything, I'm just letting you know, if you ever ask me who I use to set my stuff up.

Well that's who I use. I've done them, done it for years. I've worked with them. They understand what we do, right? They understand what we do. But when you start getting to that high level, then you might want to start looking at multiple layers of anonymity, multiple layers of structure. You might want to look at LLC series and LOC umbrellas and start creating trust and beneficial rights. I mean, there's a whole another world out there of layers and layers and layers. And which state do you open them up in? People say, well, where do you have yours out? Well, I have him here, but I also have umbrella companies that are opened up in Delaware and I have some in Las Vegas. The reason that I have those is because they own other LLCs. Those states are what we call an anonymity state.

Anonymity means that they don't have to say who owns the LOCs, like it just says the LOC, but it doesn't say who owns them. So, it's not as easy for an ambulance chaser, an attorney that chases the ambulance to take you up and see what your net worth is and sue you. Their anonymity is great. I love the fact that it has anonymity, but does it mean that if they're not, they're subpoenaed? Yeah, you disclose the information or if they subpoena you, or do a discovery, then yeah, they've broken your valve and now you've got to disclose that information. It's just some things you got to start thinking about. So, do I open up an LLC for every property I own? No. I have what's called an equity cap.

So, what that means is, like I don't have a problem putting multiple properties into one LLC, but I won't let that LOC exceed like a quarter of a million dollars in equity. Now, if I have one property that has a quarter of a million dollars in equity in it, obviously I put it in its own LLC, but the reason that I do that and some people go, oh, well that's a lot of LLCs. Oh, my goodness. Yeah, it is, but it's for protection. It's for protection because if you have all your eggs in one basket and somebody decides to step on that basket and then they're all broken. But if I moved my eggs around into multiple baskets and somebody decides to step in one basket and then I got all my eggs in the other basket. Okay, and that's the whole purpose of it because you know it's not about if you will be sued, it's about when will you be sued and it's about who's going to sue you, right?

That's where it really lies as a real estate investor. So, if you as a real estate investor start putting your protection in place and it could just be a little LLC. The beauty of that is, who is going to sue you and in most cases is real estate investors. The person who was going to try to sue you will be a renter because they're looking for an easy payday. They're looking for like that lady that walks through Walmart and hits the shelf. So, a cooler hit around on her head and she follows down and wants to sue him for $160,000,000. Thank goodness Walmart had that camera there, right? Well the problem is, we don't have all that on a rental property and most tenants are looking for some easy way out. And I'll give you some examples here in a minute, but they don't have, in most cases a lot of money to fight a lawsuit.

So, they go find an ambulance chaser that tries to see if the entity has any assets or vulnerability that they can break through to come after the owner and does the owner have assets that they can sue. So, they look at it from a pro bono type situation and it's like, look, I'll take your case because I think I can sue Jill over here. And Jill's got a whole bunch of stuff that if I can break her veil, I can go after her personally and we'll get her house or car and her savings account. Well, we'll get all that. That's what these ambulance chasers do, right? If you have your entities set correctly and you're doing what you're supposed to do, they can't break the veil. They can only sue the entity. So, a renter doesn't have the ability to fight that in most cases.

If you have enough entity in place, you can't get thrown under the bus for a frivolous lawsuit. And a lot of times that's what they are. They're frivolous and they just want you to pay him out to go away because they say, look, it's gonna cost you $15,000 to fight us in court. Just pay my client five grand and move on. That's what they come at you with. I mean, it's literally a shakedown. And ask me how I know, like it's a shakedown. And so, if you're not set up correctly, then they're going to shake you down. I'll give you an example. First time I ever got sued in real estate, I was literally packing the U haul in my front yard in California trying to get to Alabama and got served, couldn't get California fast enough, give me one more day, I would have been gone.

I got served with a lawsuit, $150,000 lawsuit. About fell off my chair, like I didn't even know what I was supposed to do and it was all over a guy that I had wholesaled some properties to and I had done what's called wholesaling to a finance buyer. And so, he was getting financing and I got paid out of escrow. So, I'd made a good bit of money on this deal that he was suing me over. And he was in a house out in a place called Orinda, California and very high-end homes. And I made $100,000 assignment fee on this deal. And he was suing me for $150,000. $100,000 back plus 50,000 in legal fees. He said I was in breach of contract. That's what he was trying to say. I was in breach of contract and a bunch of other things.

Well, here's the thing, I couldn't be in breach of contract. So, if you understand breach of contract, breach of contract says means you didn't perform your agreement in the contract, which means the contract never executed to a close. Right? But think about this. When I'm wholesaling to a finance buyer, I get paid out of what? Escrow, which means escrow doesn't pay out unless that escrow's been funded and the transactions getting closed, right? Which means there was no breach of contract. Hey, just bought a house during 2009, 2010 didn't touch the property for two years. This $1.9 million re-modeled house was now only worth $800,000. And he was hurt. His feelings were very, very hurt. He was ready to crawl up in a corner and cry, but his resolves were, I'll just sue everybody and get some of my money back.

But here's the sad part. It took me $20,000 to get this guy on the stand to say yes, he got paid out of escrow, and then my attorney says, well, do you understand the definition of breach? No. Well, here's what breaches, so could me of client breached your contract if he got paid out of escrow, which means escrows, a third-party neutral company that only executes payouts once escrows being closed. And he was like, well, I guess not. So, he asked him again, what was my client in breach? And he said, no, I don't guess he is. And that's literally what I had to pay for to prove to the point that I was right. So, the downside of that was, as he sued me personally, because I didn't have an entity in place, do you understand? It was so easy to come after me. So that was a lesson learned the hard way. Very hard. I'll give you another lesson learned the hard way. Well actually it wasn't learning the hard way. It was just something that happened. What's the lesson here? I didn't really know what the lesson is, but I'm going to share the story with you anyways.

I had a fourplex that I owned and during my lovely separation and divorce I had to sell everything I owned, which was a hard pill to swallow, but I have rebuilt. But during that time, I had to sell everything.

So, one of the fourplexes that I owned, I sold well, I guess it was like six months later I get this lawsuit in the mail coming at me for, man, it was like 300 something thousand dollars plus all this other stuff because one of the tenants was walking down the stairs and slipped and broke his hip. And so, they were coming after me to sue me. Well, thank goodness I was able to say, look, I don't own it anymore. So, the lesson in that was, it was a good thing. I had to sell all my assets. But that just goes to say like, they're always looking for something and here's the lesson in this. When I sold that fourplex to the lady that bought it, I told her, look, those steps are coming down off the second floor. When it rains it gets slippery. You might want to pressure wash them and put those lgrip stickers. Put some grip stickers down on those stairs so that people don't slip. I did tell her that and she didn't listen to me. She did not listen to me and they got sued. I didn't own it anymore, so I was out of that one.

You've been listening to the real estate investing talk show. I'm Zack Childress and I'm on a mission to create 10,000 real estate bosses over the next year. Will you be one of them? Head over to my website, ReisuccessAcademy.com/web class and register for my free web class where you'll discover how to escape from the nine to five grind and become your own boss in real estate. See you there.