EQUITY STRIPPING 101

Equity Stripping: What Is It and Why Consider It?

If you have been involved in real estate investing, you may have heard the term "equity stripping." Equity stripping is a method of removing your equity (the equity of your LLC) from a property. One of the reasons for equity stripping is to limit the potential loss that could occur as a result of a law suit or legal claim, with the resulting possibility of a lien being placed on the property. Another reason for equity stripping is to pull non-taxable cash from a property that has appreciated or has a mortgage that has paid down significantly allowing for refinancing.

Some of the types of legal problems that you may encounter, in addition to the standard slip and fall or physical injury occurrence on the property, include:

Environmental exposure to things such as lead paint, asbestos, mold and air quality issues.

HUD disputes, IRS disputes, state and local government problems.

Disputes generated by tenants over various issues, which may include discrimination, lease interpretation, claims of poor management, injury due to another tenant's pet or other injury, and any other potential problem a tenant can conjure up.

Tradesman disputes over work performed or materials used.

General business disputes that can put the equity of your property at risk.

You should always have insurance. However, some things such as environmental problems, housing violations and business disputes may not be covered by insurance.

The Importance of Creating Various LLC's

When investing in real estate it is strongly suggested that you set up LLCs as the owner of the property. You should also be careful to limit the number of properties in that LLC. It is generally recommended that one property be in an LLC, although if there is very little equity to begin with some people opt to put more than one property in the LLC. An LLC is viewed as a separate and distinct entity from you and any other corporation, LLC or entity. Since it is viewed as an entity in and of itself, lawsuits and actions brought against the LLC will normally only put assets at risk that are owned by that LLC. Your personal property will not be at risk, however in some cases of fraud or gross negligence in performance of duties the courts have held individuals responsible and liable.

Aside from refinancing with a commercial lender, thus increasing the debt and reducing your equity, some people may use one LLC to strip equity from another LLC. You will be able to establish a new mortgage through another LLC that is also your LLC. Your current equity can become debt of the LLC that owns the property. You, in effect, become the mortgage company.

As a mortgage holder you sidestep a number of problems that you could face as a property owner with equity. There is little or nothing for someone to gain as a result of a lawsuit. Furthermore, multi-member LLC's, which are treated as partnerships in the eyes of the IRS, may have lower risk of IRS audits.

This method still requires you to maintain the distinction and separation from you as an individual and from the LLC's. This means separate bank accounts, separate minutes, separate documents etc. Arm's length transactions, with the appropriate documentation, is a must.

Equity Stripping: Step by Step

An example of how equity stripping might work:

You have a building in "My Property LLC" valued at $500,000 with a first mortgage of $300,000. You decide not to refinance because your interest rate is very

favorable. So, your concern here is to greatly reduce or eliminate the $200,000 of equity that could be at risk in the event of a law suit.

You set up a second LLC, let's call it "Lender of Choice LLC," that you set up as a lender. "Lender of Choice LLC" will now loan an amount to you first LLC, "My Property LLC," which holds the property.

Let's say the loan is for $150,000, leaving only $50,000 of equity. You actually put the money into the "Lender of Choice LLC" bank account, and after the appropriate legal documents and lending criteria are met, the money is moved to "My Property LLC" as a second mortgage from "Lender of Choice LLC". The paperwork, mortgage and note, are filed with the town records.

Assuming you do not have the $150,000 to lend, you would get a personal loan from any available source, put the funds into the "Lender of Choice LLC" as a capital contribution. Then the "Lender of Choice LLC" makes the loan to "My Property LLC", with appropriate documentation and legal filings. Once the funds are in "My Property LLC" the funds can be distributed to the owners (you).

So, it really is the "circle of life" of the money. From you it goes to the lender LLC as a capital contribution. From the lender LLC it goes to the property owner LLC ("My Property LLC"), from the property owner LLC it can be distributed and goes back to the LLC member(s)(you) as a distribution.

It is sometimes suggested that LLCs in this scenario be multi-member LLCs for the sake of being able to file tax returns as partnerships. However, you can see here that by refinancing or by creating your own lending LLC, it is possible to further protect the property in your LLC that holds the asset. This can all be done in a very short period of time. If there is concern about the money being borrowed from an outside source, the distribution back to you (this would allow for the $150,000 personal loan to be repaid) could conceivably be done in a day, if necessary.

The repayment of the loan between the two LLC's can be on demand, monthly or however suits the needs. If it is a demand note, interest can accrue and increase the debt, thus continually keeping the equity of the property low. If there is concern in general about this technique, consider setting up a line of credit extended to "My Property LLC" by "Lender of Choice LLC". Again, proper legal

documentation is critical. The lender can still record this lien in the town records, and the “My Property LLC” could conceivably draw down on that line.

Conclusion

There are a number of ways this technique can be further used to avoid losing your equity in the event of a lawsuit; however, it is less likely that a lawsuit will take place when an attorney realizes the lack of equity makes it impractical to sue.

In all situations such as this, seek legal and accounting advice from professionals who are familiar with this strategy. If done properly, equity stripping can provide you with tax free cash as well as protecting your assets from legal complications.