Choice of Entity 101

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One of the most common questions that real estate investors ask is: Which entity should I use? The correct answer usually depends on a large number of details…the exact nature and size of the business, the investor's source and type of income, the number of family members, etc. This article will set out some general rules for picking a structure. Your mileage may vary based on your own personal facts and circumstances.

Rule One: Limited Liability Company's (a.k.a. – LLC's) are generally the way to hold rentals and most lease-optioned properties.

The asset protection aspect of entities usually matters little when selecting an entity. That's because in most states, LLC's are cheap, provide the best asset protection and are tax chameleons, meaning that they can select how to be treated for federal income tax purposes. So when I say that a corporation works best for you, what I really mean is that an LLC that elects to be treated as a corporation is the best choice in most states.

What really distinguishes entity types is the tax treatment accorded each one. As such, choice of entity usually turns on the applicable tax rules. In fact, tax rules will determine the best entity for rentals, because they are the little darlings of the tax code. Specifically, rentals:

- sell at favorable capital gains tax rates;
- generate depreciation deductions;
- generate tax upon sale that can sometimes be paid in installments, instead of all at once;
- can be exchanged for other real property tax-free; and
- may generate low-income housing credits

We want to select an entity that preserves these tax perks. Limited Partnerships ("LPs") and Limited Liability Companies ("LLCs") both achieve this goal better than any other entity. In most states, an LLC is cheaper and simpler to set up and run, so it is normally preferable to an LP. In addition to preserving rental property tax perks, LLC's are the most flexible entity. Corporations have various restrictions on who can be an investor, what kind of income can be earned, etc. LLC's are thankfully free of such pesky (and time consuming) issues.

Rule Two: S-Corporations are usually the best way to flip properties.

First, let's distinguish S and C corporations. A C-Corporation is taxed on its income at special corporate rates. Any income that is paid to shareholders as a dividend is taxed again. This is the famous "double taxation" that applies to C-corporations. For example:

Trumpco Incorporated earns $10,000 in taxable income. It pays a 15% tax on that income, or $1,500, leaving with $8,500 in after-tax income. It pays an $8,500 dividend to Trump, its owner. If Trump is in the 35% tax bracket, he will pay $2,975 in taxes on the dividend, leaving Trump with $5,525 of the original $10,000.

This double tax can quickly cost corporate shareholders more than 50% of their corporation's profits. Fortunately, the income of a C-Corporation can often be finessed to reduce the double tax. Oftentimes, creative means of getting money to shareholders (e.g. – renting equipment to the corporation, taking salaries, etc.) can also eliminate one layer of taxation.

To offset the double tax (or the administrative cost of getting around it), C-corporations have a few unique perks enjoyed by no other entity. Employees (including shareholder-employees) can get certain benefits (e.g. - medical, favorable retirement plans, tuition payments) tax-free.

S-Corporations do not get the above perks, but they also do not have double-taxation issues. As such, they are "pass-through" entities. Following the Trumpco example from above, the $10,000 dividend to shareholders would only be taxed once, at the shareholders 35% rate. S-corporations are much simpler than C-corps, and therefore cheaper to operate. They are less flexible than LLC's, but have one important advantage: S-corporation dividends are exempt from social security taxation if the S-corporation owners are paid a reasonable salary. This feature is quite important, because income from flips (as opposed to rentals) would otherwise be subject to a 15% social security tax.

For example:

The incredible Flipboy makes $80,000 in net income from wholesale flips done through an LLC. He would pay approximately $12,000 (15% of $80,000) in social security taxes. If he used an S-Corporation and paid himself a "reasonable" salary of $35,000, he would only pay social security tax on the salary, or $5,250. The remaining $45,000 in profits would be distributed without paying additional social security taxes, saving Flipboy $6,750 in social security taxes.

Limited partnerships are also exempt from social security taxes. Arguably, LP's are not required to pay a reasonable salary, meaning that all of the LP's profits can be sheltered from social security taxes. The catch: LP's are significantly more complicated than S-corporations and therefore more expensive to run. The extra benefit of an LP over an S-corporation for flips must be weighed against the cost.

Rule Three: C-Corporations often make sense for high-income individuals with self-provided benefits.

As we stated above, C-corporation can provide certain perks and benefits tax-free. If you do not have a day job (or a spouse with a day job) that provides such benefits, getting

them through a C-corporation can be very efficient from a tax standpoint. Also, I mentioned that C-Corporations pay taxes based on their own brackets. For example, the first $50,000 of C-Corporation income is taxed at 15%. For people in the 35%+ tax brackets, running $50,000 or so in income through the C-corporation at a 15% tax rate can be quite favorable. I say "can be" because C-Corporations are fairly expensive to administer. Remember, the benefits must outweigh the costs (e.g. – extra tax returns, bank accounts, etc.).

I rarely place a major business in a C-Corporation. Instead, I like to see secondary businesses put into a C-Corporation. For example, a C-Corporation that manages your rentals is paid what you choose to pay it (within reason!). You can pay it enough to fund your benefits, but not so much that double-taxation becomes an issue. If you put a major business into a C-Corporation, it may make "too much" income. At worst, the double tax kicks in, costing you big dollars. At best, your tax advisor finds a way to bail the income out of the company….and charges handsome fees for the favor! In my view, it is much easier to put the C-Corporation on an "income diet" than it is to "lose" the income later on (Sound familiar?).

Rule Four: Incorporate in Your Home State

I have yet to see a Nevada entity used to hold or flip properties that justified its cost. All of the benefits promised by Nevada entity hucksters (e.g. – privacy, no state tax) DISAPPEAR because you are doing business in YOUR state. Nevada entities CAN be used to reduce income taxes in SOME states by charging your in-state company interest – talk to someone familiar with YOUR state's rules to see if such an arrangement is legally possible AND worth the cost and hassle. Do NOT accept the word of a guy who sells Nevada entities for a living. Shockingly, he will assert that a Nevada company will save taxes, promote privacy, make you better looking and cure cancer…all without having the first clue about the laws in YOUR state. To a guy with a hammer, everything looks like a nail!

Rule Five: Your Mileage May Vary

These are general rules. Your business, personal situation or state's laws will often make for exceptions to the general rules. Get qualified advice!