Choosing a Business Entity for your Real Estate Activities

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There are many different business entities that a real estate investor should consider when starting their real estate company. However, there is no “one size fits all” entity for every investor. Each entity has its advantages and disadvantages, and it is only with careful planning that a decision should be made. We will describe the 3 basic entity types in this article and some things you should consider when forming one.

<u>C-CORPORATION</u>

A C-Corporation is simply a separate business entity (sometimes called an “artificial person”) that is organized under the laws of a state and is completely distinct from its owners. A C corporation is basically any for-profit corporation that did not make an election to be treated as an S corporation. It is called a “C” corporation because it is governed by Subchapter C of the Internal Revenue Code. All C-Corporations are treated as separate entities for tax purposes and must file an income tax return (Form 1120) each year.

A C-corporation must file its own tax return (Form 1120) every year and it is taxed on its net profit (after business expenses have been deducted). Depending upon the net income of the business, it may be advantageous for the business to be taxed at the corporate level, as the tax rate may be lower than it would be at the individual shareholder’s tax rate level. C-Corporations can also have a medical reimbursement plan for its employee/owners, which can provide a very nice tax benefit for those who have high medical expenses.

One of the other big advantages of a C-Corporation is that it provides personal liability protection for all of its shareholders. The disadvantages are potential double taxation to the corporation and its shareholders, potential accumulated earnings taxes and reasonable compensation issues. We generally look to a C-Corporation for our real estate investor clients who are real estate dealers (i.e. those who are in the business of fix and flips), management companies, and real estate brokers.

<u>S CORPORATION</u>

An S corporation is identical to a C corporation except that it makes an election with the IRS on Form 2553 to be treated as an S corporation. The main difference between a C and S corporation is the way the corporation is taxed. An S corporation is required to file a tax return (Form 1120S) but it does not pay any income tax on its net business income. Instead, the shareholders pay tax on the corporate income based upon their percentage of ownership in the corporation (i.e. an S-Corporation is a “flow-through” entity).

Some of the advantages of an S-Corporation are that the S-Corporation provides personal liability protection for its shareholders, it avoids the double taxation problems of a C corporation, and there are no accumulated earnings tax issues with S corporations. An S-Corporation is also a viable entity for saving employment tax dollars for employee/owners of the company required to take out a reasonable salary. The disadvantages include being limited to 100 shareholders in the corporation, only having the ability to issue one class of stock, the lack of the ability to have a medical reimbursement plan like a C-Corporation, passive activity loss restrictions, and reasonable compensation issues. We recommend using an S-Corporation for real estate dealers, real estate brokers and management companies.

LIMITED LIABILITY COMPANY (LLC)

A limited liability company, or LLC, is a mix between a corporation and a partnership. It is similar to a corporation because it limits the personal liability of its members but is taxed like a partnership. An LLC is very flexible in that the company can elect taxation depending on the needs of the owners. An LLC can be taxed as a C-Corporation, and S-Corporation, a Partnership or a Disregarded Entity. An LLC is also a “flow through” (with the exception of an LLC taxed as a C-Corporation) business entity, meaning the LLC itself does not pay any tax on its profits, the individual owners do.

The advantages of an LLC include personal liability protection for its members, no double taxation issue if the LLC is taxed as a partnership, no accumulated earnings tax problems, and no reasonable compensation issues. The disadvantages include having to pay self-employment taxes on earned income generated through the LLC, lack of the ability to have a medical reimbursement plan like a C-Corporation, and certain passive loss restrictions on passive investment losses passed down to the owners of the company. We usually recommend using a LLC for real estate rental businesses, long term investment property (i.e. property held a year or more), and as holding companies for investors with multiple rental properties or significant assets.

As you can see, the three main entity types have their advantages and disadvantages. It is important that you work with your legal professional to help you decide which entity is right for you, as the formation of such an entity is dependent on the owner’s individual facts and circumstances. The formation of these entities can be costly in both formation costs and ongoing maintenance. For example, most of these entity types will require a separate tax return be prepared each year. Additionally, different Secretary of State offices charge different fees to have an entity formed. There also may be additional fees such as for bookkeeping for the entity and transfer taxes. Although such costs can be looked at as part of doing business (and in most cases tax deductible), each owner should understand the pros and cons of adding such a structure to their current real estate business.