Entities for Business and Real Estate Investing 2011

By Bradley S. Dornish, Esq.

Fall is the time to plan your entity structure for your business for the coming year. You want to have everything set up the way you want it, and enough time to make the transition on January 1st. Of course, you can start a new entity any time you need to, but changing your structure for the New Year works best for tax purposes. You finish the current year with your current structure, make the changes for January 1, and start the New Year with your new structure. Your tax returns for the old year reflect the old structure, and your tax returns for the New Year reflect the changes, without any partial tax years in either structure. That keeps your accounting fees to a minimum.

But before you figure out the changes you want to make, you have to understand the basics about entities. First, what is an entity? It is a separate legal person designed to have an existence apart from you individually. An entity can enter into leases and other contracts, own real estate, sue and be sued in court, all without naming you individually. This is good for most businesses, but especially for real estate investing, where the public records like deeds and mortgages are abundant and easy to track.

There are simple benefits to having an entity, like reducing the appearance of your name in courts and other public records, leases and contracts. Entities can also protect you from certain claims and liabilities, reduce your risk of tax audits, save tax dollars, and reduce your exposure to mechanics' liens.

Entities help me to keep only personal loan accounts on my personal credit report and to keep my business loan accounts off of my personal credit report. The more money you borrow for real estate investing, the more of an advantage this can be. Try to get a personal credit card or even a car loan when you have over a million dollars of real estate related loans and fifty utility accounts on your personal credit! But the entity's accounts don't appear on your credit report, because they aren't personal to you, although you probably have to guarantee them all.

When you flip properties, using the right entities can keep claims from properties you rehabbed six to twelve years ago from coming back to affect your profits today. They can also protect your profits next year from claims arising from your current rehabs. You can also control “dealer status” for tax purposes, which is discussed below

A series of entities used together can allow you to wear several hats, as owner, manager, contractor (and in my case lawyer) all while the entities interact to work with your properties in different ways, still keeping each role separate and keeping your banks happy. If you own rental properties, a series of entities can give you the convenience of common management, but can split your real estate equity in to separate pieces, so “all of your eggs are not in one basket” and you don’t lose all of your equity as a result of an uninsured claim or problem at a single property.

Once you understand what entities can do, the next question is which are right for you? Corporations, Limited Liability Companies, Limited Partnerships and Trusts all have roles in businesses in general, including the business of real estate investing, but their roles are different.

A corporation or limited liability company works as an entity for a single business in any field, and particularly in real estate to flip a series of properties and then shut down and form another, managing both claims exposure and tax issues. We prefer LLC’s for our clients over corporations, because both can be treated as S or C corporations for tax purposes, but the LLC has even more flexibility, being able to be taxed as a pure pass through or partnership as well, depending on who owns it. The LLC is also easier to maintain than a corporation, not requiring annual meetings and minutes to preserve its separate identity. There are potential tax issues looming for 20011 for single member LLCs structured as pure pass through entities, so make sure you consult your C.P.A., tax accountant or tax advisor as the dust settles in this area by the end of the year, or early in 2011, after the newly elected Congress convenes. An entity can elect corporate “S” status until March 15^{th} for the current tax year, so make sure you know what is best for you, and get it done by then.

An LLC or corporation can also make a great property management entity for your long term holdings. Although you have to be a real estate broker or an owner of real estate to manage it, I use LLCs as the general partner in each of my Limited Partnerships holding title to real estate. That way, the deeds to different groups of rental units are in different LPs, so my equity “eggs” are in different baskets. But, at the same time, all of my leases, management activities and liability exposure from management are centralized in a single LLC. Since it owns 1% of the Limited Partnerships which own the properties as general partner, the LLC manages as an owner without being a real estate broker. This does not work in Pennsylvania with two layers of LLCs, only with an LP as owner and an LLC as its general partner.

One set of bank accounts, one phone number, and one name to do business under all help to make management easier. The structure also has asset protection benefits, because the LLC is like a lightning rod for claims arising from management activities. It takes the heat, and diverts the attention from your LPs. But it also only owns just one percent of your equity, so the other 99% is protected from those claims. The LPs do no business, since they are just shells holding the deeds, so they don't even need their own bank accounts. And since any contracts for repairs or improvements are between the contractor and the LLC managing the property, there is no contract with the LP owner, so the contractor can't lien the property of the LP if the LLC doesn't pay.

Of course, the next question is how many LPs to have? Ideal asset protection would be to have every single family house duplex or multi-unit property in its own LP. Each would then be in its own "liability basket', protected from the legal liabilities associated with other properties. However, each entity you form and operate has its own legal existence, including a tax ID and corresponding obligations to report and pay certain taxes. This adds a cost to each entity, and you have to balance ideal asset protection against the guaranteed costs and ease of operation of doing business every year.

I choose a compromise between these two objectives, and try to structure real estate holdings almost evenly over five different limited partnerships, so that only about 20% of equity is at risk for any given potential liability. Some people prefer more or fewer LPs, depending on how much they are willing to pay and do each year to protect more of their assets from potential future claims. This is something like deciding how much insurance to buy. You need to find the balance that works for you.

The same analysis applies to the number of layers of entities you use. Some people add another layer of trust under their LPs, or manage different groups of LPs holding properties with different LLCs. I try to remind client that they can protect themselves so well that they spend too much of the revenue of their investment properties on protection, and don't make any money. After all, making money short term or long term, or both, is the purpose of investing in real estate to begin with. If you protect yourself so well that you aren't able to make money on your investment, then you shouldn't be investing in real estate. Buy a Savings Bond or put your money in an insured certificate of deposit and you won't have to worry about entities or making more of a return in real estate.

You will hear that buying your properties in entities makes it harder to get them financed, but that is only partially true. Certain lenders like Wells Fargo and Countrywide/Bank of America have had policies for a few years that they won't loan to entities, but only if you hold title in your own name. But if your credit is around 700 and the property on which you want to borrow cash flows and appraises, you can go directly to most local banks and get a mortgage loan in the name of your entity, which you guarantee personally. If you use a mortgage broker experienced in working with investors and entities, the broker won't even apply to Wells Fargo, Bank of America or other lenders who won't loan to entities for your loan, because they also know these lenders' policies. You should never be in the position where you are approved for a loan, but at the last minute have to transfer title to your own name to close. That comes from a broker who didn't do his job finding the right lender. It also defeats your asset protection and business strategy, and costs extra transfer taxes as hidden costs of your loan. Find a lender or broker who will get a loan for the structure you have, instead of changing your structure for a loan.

If you use hard money or private loans to buy and renovate your properties, most hard money and private lenders will also loan to your entity with your personal signature on the loan. As long as they have a valid first mortgage from the entity owning the property, and you are the owner of the entity signing the note, everything should work out if you pay the loan, and it should be easier for you to give and the lender to accept your deed in lieu of foreclosure if you default. We close these loans all the time, and explain these issues to private lenders if they have any doubts.

Another issue to touch on is the choice of registered office for your entity. A registered office is the place in Pennsylvania where a sheriff's deputy can serve your entity with a lawsuit. That means it has to be a physical address, since a deputy can't hand suit papers to a post office box. Of course, using your home address means the deputy may be waiting for you or an adult in your home. Your spouse, mother in law staying with you, cleaning lady or child 18 or over all come to mind, and none are particularly good alternatives. If you have an office where you do business, that can be your registered office, but you have to remember to change it when you move your office, and pay the fee of $70.00 to change.

For years I have offered my clients the ability to use my office for their registered address at no charge. This made sense since we are open 8 to 5 on week days, and nobody thinks it unusual for a sheriff's deputy to visit a law office. This year, I became concerned that I would be changing my office address when I sell my building, and didn't want to have my clients pay the charge to change their registered address to follow me. I found a solution by registering as a Certified Registered Office Provider with the Commonwealth of PA. Now, my out of state clients, and those in state who don't want to use their home or office addresses for their registered address, can use my office, still at no charge. When I move my office, their registrations follow without paying the extra $70.00 each.

I have also added an extra expediting service so formation paperwork can be hand delivered in Harrisburg the same day an entity is requested, so we aren't waiting a week or ten days to find out if an entity is formed. For an extra $35.00 per entity, they can be set up in a day or two. When clients procrastinate, and are waiting to sign contracts, this service can make the difference between losing and saving a deal.

Of course, even a two thousand word article isn't enough to cover a three hour seminar on entities, but the information on how to use entities in PA hasn't changed much from the last time I gave the entities seminar. That three hour seminar is recorded and still available if you need more information to plan your entity structure for real estate investing and I'll always give ACRE members a free consultation!

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