ENTITY SELECTION

FOR REAL ESTATE INVESTORS

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Entity Selection for Real Estate Investors

The process of buying real estate as an investment typically requires more than deep pockets. Investors must understand that taking certain precautions to organize their holdings and protect their assets is a must for long-term wealth. This white paper is made available for educational purposes only, as well as to give general information regarding the different entity types and is not meant to, nor does it, provide legal advice.

To properly structure assets, investors must understand the options that are available and choose among them.

About the Authors

Jason Powell is an experienced corporate, securities and real estate attorney. He prides himself on a taking a creative approach to problem solving. Powell focuses his work on corporate governance and law, including business planning and entity formation, business transactions, contracts, securities offerings, real estate transactions and commercial and private money loan transactions. He is also an active real estate investor.

During his legal career, Powell spent almost five years as General Counsel for two start-up real estate companies and, as a result, has a unique perspective on legal matters related to businesses and start-up companies.

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Golhar began investing in real estate in 2002 and has always used a “value-added” approach to identify acquisitions. He educates thousands of people every day on his radio show, podcasts, and YouTube shows. Golhar enjoys working with investor groups to implement market-driven strategies which have the highest potential for success in emerging markets.

What Are the Different Types of Entities?

The first consideration for real estate investors is what to do to protect their assets once they have acquired them. The issue of entity selection is one Jason counsels clients on daily.

One thing Jason makes a point of noting with clients is there are always options when it comes to forming business entities. The solution that works for one investor may not work for another.

Before making a choice, it’s important to understand the options that are available and the potential value—and risks—of each.

So, let’s look at each entity and review what using them would mean for investors.

Limited Partnership (LP)

A LP is an entity formed by two or more parties who unite for the purposes of running a business—in this case, a portfolio of real estate business. Each partner has a financial interest in the business.

The "limited" designation means, simply, that each limited partner is liable for the financial obligations of a limited amount. Historically, and still according to a vast amount of case law and statutory law, the limited partners in a LP are not personally liable for the operations of the LP.

A LP is run by one or more general partners, who are responsible for all managerial and business decisions. In a LP, the general partner is personally liable and in all cases the general partner will be a shell/management company such as an limited liability company (LLC) or corporation.

The LP has historically been a fantastic entity for inside and outside charging order protection, in most states. A charging order is an order obtained from a court or judge by a judgment creditor, by which the property of the judgment debtor's assets (including the partnership interest in a LP) stand charged with the payment of the amount for which judgment shall have been recovered, with interest and costs. A charging order places a lien on say a limited partner's partnership interest and allows the judgment credit to collect distributions or assets that are due to be paid to the limited partner that is the judgment debtor.

If additional partners are involved, they will contribute capital but are silent or limited partners who generally are not involved in decision-making, but may have certain voting rights with respect to certain major decisions.

Limited Liability Partnership (LLP)

A limited liability partnership (LLP) is different from a LP. A LLP differs from a LP because all partners in a LLP are shielded from wrongful acts or negligence of other partners.

A LLP offers a way for all partners to be involved in the running of the business—as contrasted with a LP, where the general partner takes the lion's share of the responsibility. In a LLP, all partners share in the responsibilities and liabilities as there is only one class of partner – general partner.

However, as the name implies, the liability of each partner in a LLP is limited. The limits on liability may vary depending upon where the entity is formed. Some states only limit personal liability for the negligence of a partner. Some states take a middle ground, and limit personal liability for a partner's negligence, as well as for partnership contracts and other debts (in other words, a partner is only personally liable for his or her own negligence). Nevertheless, as a general rule, the partners' personal assets are protected and may not be seized to relieve the obligations of the partnership—although an individual partner may be sued in the event of wrongdoing.

For tax purposes, a LLP is a pass-through organization meaning that each partner must file and pay taxes on their income from the entity. The LLP is a fantastic option for licensed professionals and to be owned by S-Corporations for tax purposes and generally the LLP structure is not used outside of licensed professionals. In some states the LLP may only be used by licensed professionals.

Limited Liability Limited Partnership (LLLP)

A LLLP is a relatively new type of business entity. The LLLP includes one or more general partners and one or more limited partners. The general partners bear the responsibility for managing the partnership, while the limited partners have only a financial stake in the LLLP.

The LLLP is a type partnership that also provides limited liability for the general partners of the LLP. This is unlike a LP as stated above, where the general partners are jointly liable for all obligations of the partnership. Thus, an individual could ostensibly serve as the general partner in an LLLP individually and they wouldn't be personally liable for the operations of the LLLP. However, we feel that if a LLLP is warranted in a particular situation, then it is well worth the cost to have a shell entity (LLC or corporation) serve as the general partner so there is an extra layer of protection and the risk isn't born personally by the general partner.

LLLPs are not available in all states and we believe that the LLLP may be oversold and over emphasized in certain investment and asset protection circles. We believe the only time to consider a LLLP is in states where LP common law protection is weak and a LLLP statute is on the books. If you do use a LLLP make sure that you also use a shell company (LLC or Corporation) as your general partner.

Limited Liability Company (LLC)

A LLC is a separate and distinct legal entity. The primary advantage of an LLC is that its owners, known as members, have "limited liability," meaning that, under most circumstances, they are not personally liable for the debts and liabilities of the LLC.

LLCs limit personal vulnerability to potential lawsuits related to a property, which is perhaps the most intriguing aspect of starting a LLC. Any lawsuit that comes against a LLC is aimed specifically at the company, not the individual responsible for it. If the property in question is owned by a LLC, the owner's risk exposure would be insulated by the protection of the LLC, leaving only the assets owned by the LLC (as opposed to all of the owner's personal assets) exposed to potential lawsuits. In other words, personal finances would not be in jeopardy.

While LLC owners enjoy limited personal liability for many of their business transactions, this protection is not absolute. This drawback is not unique to LLCs, however -- the same exceptions apply to corporations. A LLC owner can be held personally liable if he or she:

- personally and directly injures someone;
- personally guarantees a bank loan or a business debt on which the LLC defaults;
- fails to deposit taxes withheld from employees' wages;
- intentionally does something fraudulent, illegal, or reckless that causes harm to the company or to someone else, or
- treats the LLC as an extension of his or her personal affairs, rather than as a separate legal entity.

To combat the above exceptions to personally liability for the LLC owners, the LLC owners should:

- not conceal or misrepresent material facts or the state of your finances to vendors, creditors or other outsiders;
- invest sufficient cash in the business so that your LLC can meet foreseeable expenses and liabilities;
- obtain a federal employer identification number, open up a business-only checking account and keep personal finances out of the LLC accounting books; and
- have a formal written operating agreement to lend credibility to the LLCs separate existence.

As mentioned above, when forming a LLC, it is critically important to have an operating agreement, which governs the internal structure, organization and management of the LLC. Without an operating agreement, the LLC is governed the default provisions set forth in the statutes of the state in which the LLC is formed.

In our opinion, the LLC is the most flexible entity structure and is typically the structure that is uses most often by real estate investors.

Corporation

A corporation is a formal entity governed by a strict set of rules and regulations. It is the most complicated of all entities to form, yet it provides the most protection from financial liability.

As a legal entity, a corporation is completely separate from its owners. It has many of the same rights as an individual, meaning that it can do all of the following:

- Negotiate and enter into contractual agreements;
- Loan money or borrow money;
- Sue individual or entities and be sued by them;
- Own assets; and
- Pay taxes.

Corporations are owned by a number of shareholders ranging from one all the way up to thousands for publicly-traded companies. The percentage of profits or dividends received is commensurate with the shareholder's stake in the company.

A corporation offers the highest possible level of protection from personal liability. The principles, including officers, directors, employees and shareholders, have no personal obligation to take responsibility for the financial obligations or debts of the corporation. However, there are circumstances in which limited liability will not protect an owner's personal assets. An owner of a corporation can be held personally liable if he or she:

- personally and directly injures someone;
- personally guarantees a bank loan or a business debt on which the corporation defaults;
- fails to deposit taxes withheld from employees' wages;
- does something intentionally fraudulent or illegal that causes harm to the company or to someone else, or
- treats the corporation as an extension of his or her personal affairs, rather than as a separate legal entity.

In certain circumstances, like those set forth above, courts can rule that a corporation doesn't really exist and that its owners should not be shielded from personal liability for their acts. This might happen if the owners fail to follow routine corporate formalities such as:

- adequately capitalizing the corporation;
- formally issuing stock to the initial shareholders;
- regularly holding meetings of directors and shareholders; or
- keeping business records and transactions separate from those of the owners.

Corporations must observe certain formalities to preserve the corporation's status as a separate entity. Specifically, corporations must:

- hold annual shareholders' and directors' meetings;
- keep minutes of shareholders' and directors' major decisions;
- ensure that corporate officers and directors sign documents in the name of the corporation and not in their personal name;
- maintain bank accounts separate from the shareholders;
- keep detailed financial records, and
- file a separate corporate income tax return.

What is the Process to Form Each Entity?

Now that we have explained the different entities available and talked about the differences between them, let's look at what is required to form each one. The formation of partnership is relatively simple while the formation of a corporation is most complex.

Forming a Limited Partnership (LP)

The filing requirements for a LP vary slightly from state to state. In some states, the requirements are more stringent than in others. The name of the document used to form a LP, with the Secretary of State's office is general referred to as a Certificate of Limited Partnership, but may also be referred to as a Certificate of Formation in certain states.

The primary document that governs a LP is the partnership agreement. The partnership agreement is a written agreement that explicitly details the relationship between the parties and the specific rights and responsibilities of each partner. The partnership agreement should, at a very minimum, address the following matters:

- The percentage ownership and contrition amount of each partner;
- The allocation of profits and losses and whether they will be allocated in proportion to each partner's ownership interest;
- Designate the general partner;
- What decisions the limited partners have a right to vote on prior to be taken by the general partner;
- What happens in the event of a partner's death;
- The process you will use to resolve disputes among partners; and
- What happens in the event that one partner wants to leave the partnership.

Even if you believe a partnership is relatively straightforward, it is best to have an experienced attorney draw up your partnership agreement. Don't dismiss the necessity for a partnership agreement because your proposed partner is a good friend; some of the ugliest partnership breakups occur between friends who assumed that they knew what their friend thought or would do.

You can find the forms and other filing requirements on the Secretary of State's website in the state in which you wish to form the LP. As mentioned above, the usual requirement to form a LP is a Certificate of Limited Partnership. The form may vary from state to state, and the filing fees are determined on a state level as well.

In the event that the LP intends to pursue a form of business activity that requires licensing or certifications beyond informing the state of your partnership's existence, the partners are legally required to obtain all necessary licenses and certifications on behalf of the partnership.

Finally, you will need to obtain an Employer Identification Number (EIN) from the IRS, which you will need to open a business bank account and hire employees. EINs can be obtained though the IRS' online portal. This is also something Jason will typically handle for all of his clients.

Forming a Limited Liability Partnership (LLP)

The filing requirements for a limited liability partnership or LLP are very similar to those for a limited partnership.

The first thing you must do is check to see if the state you want to form the LLP in offers that option. If you state offers that option, you will also want to check to see if that state puts any limitations on who can form an LLP. For example, California and New York both specify that only professional firms may file for LLP status.

A LLP is typically formed with the filing of a Certificate of Limited Liability Partnership (sometimes called a Certificate of Registration as a Limited Liability Partnership) with the Secretary of State's office. The application for the certificate requires the listing of your business' name and address, the names and contact information of your partners and name and address of your registered agent.

Next, choose a name for your entity and draft a LLP agreement. The agreement should include:

- The name and address of the LLP;
- Capital contributions and percentage interests of each partner;
- Rules for the distributions of profits and losses;
- Specifications for one partner to buy out the other;
- What happens in the event of a partner's death or permanent disability;
- What happens in the event that one partner desires to leave;
- The process used to resolve disputes; and
- Rules for the addition or expulsion of partners.

All of the other requirements for LPs also apply to LLPs, including:

- Designating a registered agent;
- Obtaining an EIN from the IRS;
- Obtaining a state ID number if required;
- Opening a separate bank account;
- Obtaining any necessary business licenses or certification to conduct business; and
- Filing annual reports per the state's requirements.

We strongly recommend getting a lawyer to draft your partnership agreement for an LLP. An attorney may also agree to act as your designated agent and handle renewals and other issues as they arise.

Forming a Limited Liability Limited Partnership (LLLP)

As we mentioned earlier, the LLLP is a relatively new entity and only available in some states. However, the formation procedure is very similar to that of a LLP.

In some of the states where LLLP formation is allowed, the fees vary depending upon whether there is an existing LP or the entity being formed is new. As a rule, it's less expensive to convert an existing LP to an LLLP structure than to start a new LLLP from scratch.

The primary difference between forming an LP or LLP and an LLLP is that you can convert an existing LP into an LLLP. The form required is an amendment to the original partnership certificate, or—in the event that the entity is new—a partnership certificate similar to those required for the formation of other partnerships.

Otherwise, the requirements are the same. You will need:

- A designated registered agent;
- A partnership agreement including all pertinent information discussed above under the partnership agreement for a LP;
- An EIN from the IRS;
- A separate bank account;
- A state ID number as required;
- Any additional business licenses as required by the state; and
- To file annual reports per the state's requirements. Filing requirements, due dates and fees vary from state to state.

Forming a Limited Liability Company (LLC)

The first step in forming a LLC is to choose a compliant name for your limited liability company. Some states have very strict naming requirements. As a rule, the LLC name must indicate the type of entity it is, so your name must include one of the following: LLC, L.L.C. or Limited Liability Company.

In addition, certain states prohibit the use of certain words in the name of an LLC. For example, some commonly excluded words include bank, city or corporation.

Once the initial members have determined that their chosen name is available and meets the state's naming requirements, they must file their Articles of Organization or Certificate of Formation (the name of the initial filing varies between states) with the Secretary of State. In most states, the Articles of Organization or Certificate of Formation involve using a template that can be downloaded from the Secretary of State's website.

You will then have to file the Articles of Organization or Certificate of Formation together with the required filing fee and name of a registered agent for service. In many cases, the agent may also be the attorney that prepares the documents. The registered agent must have a physical address in which the LLC is registered.

After that, the steps are similar to those for a partnership with a few key differences. They include:

- Check to see if the state where the LLC is formed has a publication requirement. Some few states, including New York, require that LLCs publish announcements of their formation in the newspaper at specified intervals;
- Apply for an EIN from the IRS and a state ID number where required;

- Open a bank account in the name of the LLC; and
- Obtain any necessary licenses and permits

The final step is to draw up an operating agreement that lays out the LLCs structure, operations, policies and responsibilities of its members. An operating agreement is a necessary document to protect the LLCs members and make the company's policies and structure clear. It is also a requirement of financial institutions in order to open your bank account. Without an operating agreement, an LLC is governed by the statutes in the state of formation, which is not a situation we recommend for anyone.

Some of the more important provisions that should be included in an operating agreement are:

- Capital contribution amounts of each members;
- How and when distributions will be made;
- The allocation of profits and losses;
- How the LLC will be managed;
- The manager's power and limitations;
- The voting rights of the members;
- What, if any restrictions, will be placed on the transfer of a member's membership interest;
- What form of dispute resolution the members will use in the event of a dispute;

We believe the best option is to have an attorney draft the operating agreement. The agreement doesn't have to be complicated, but it does need to be thorough and properly prepared and executed. As the number of members increase, the importance of a thoroughly, attorney-drafted operating agreement increases in importance for the protection of all members.

Forming a Corporation

The formation of a corporation is by far the most complicated process. As is the case with all entities, the first order of business is to choose a name and search with the Secretary of State's office to make sure it's available. An entity that intends to do business using a trademark or service mark will also want to do a search with the US Patent and Trademark Office.

The next step is to prepare Articles of Incorporation and file them with the Secretary of State's office. The Articles of Incorporation will need to name a registered agent. This process is identical to the one for forming an LLC and also requires the payment of any applicable fees.

Corporate bylaws are not a filing requirement, but nevertheless, every corporation needs to have them. The corporate bylaws spell out the legal rights and responsibilities of shareholders, directors and officers, including:

- The date, time and location of Shareholder meetings;
- Rules for shareholder votes, special meetings and other specification
- Rules and responsibilities for the board of directors, including designated meetings and rules for replacing a board member;
- The duties and responsibilities of corporate officers;
- Rules governing contracts, dispersal of funds and amendments to the bylaws

Bylaws are an important step to maintain the corporation as an entity separate and distinct from its shareholders to avoid piercing the corporate veil

Once the bylaws are in place, the next step is drafting a Shareholder Agreement. The Shareholder Agreement is not a requirement, but again, it's a good idea to have one if maintaining control over who can hold shares is important.

The Shareholder Agreement should lay out the rules regarding the sale and transfer of the corporation's shares. It usually spells out the procedure for voluntary transfers of stock, involuntary transfers as in the case of bankruptcy and what happens with the stocks in the event that the shareholder dies. The Shareholder Agreement should also spell out (i) how disputes will be resolved; (ii) if there is any vesting of the shares with respect to the shareholders; (iii) what events may trigger a mandatory sale by a shareholder; (iv) if there are any pre-emptive rights in the event of a proposed transfer of shares by a shareholder; and (v) any necessary valuation method for the shares for any purchase event under the Shareholder Agreement.

Issuing certificates of stock ownership is another important step for corporations. Corporations must keep track of all shares issued. They must also track the number of shares that are outstanding and how many are owned by each shareholder.

Corporations are required to maintain corporate minutes which detail the events at all board and shareholder meetings, including decisions to incorporate, open bank accounts, buying property and borrowing money.

The corporation must also:

- Obtain an EIN;
- Open a bank account in the name of the corporation;
- Obtain a state ID number where required; and
- Make a tax election to declare itself as an S corporation, if it wants to be taxed as such, as the default is to be taxed as a C corporation—the tax benefits vary so this is an important decision.

Just as is the case with the other entities discussed, corporations must obtain all necessary state licenses and certifications to do business.

The corporation is the most complicated entity to establish, but it also offers the highest degree of personal protection to the owners, directors and officers. If proper corporate formalities are followed as discussed above, it is very unlikely that any person or entity will be able to pierce the corporate veil and demand personal liability for debts.

What is the Management Structure of Each Entity Type?

Beyond financial liability and taxation, there are differences among the various entities when it comes to the management of the entity itself. We think it's important to acknowledge those differences as they many impact the decision about how to organize.

Limited Partnerships

LPs have the simplest management structure. As we mentioned earlier, a LP must designate at least one general partner. Any other partners are designed as limited partners.

The general partner(s), or GP, has responsibility for all day-to-day management and operation of the LP. In other words, the GP runs the business of an LP and has the authority to make legally binding business decisions.

The partnership agreement will specify exactly which partner or partners have certain responsibilities and which have certain authority. The general partners of a limited partnership are also jointly and severally liable for the debts of the business, just like partners in a general partnership. This is why it is imperative that the GP establish a shell company (LLC or Corporation) to serve as the GP of an LP.

Limited Liability Partnerships

The management structure of limited liability partnerships is very similar to that of an LP.

Because there is only one class of partners – general partners. The partnership agreement will delineate which general partners are assigned the responsibility for the day-to-day management of the LLP as managing general partner.

Limited Liability Limited Partnerships

As is the case in the other forms of partnerships discussed, the LLLP must designate one or more general managers to handle the day-to-day management and oversight of the partnership and any employees it may have.

The GP has the responsibility of negotiating contracts, obtaining loans, and handling all other legal and managerial requirements of the LLLP. In theory, the GP has limited liability, however, it is still recommended that you have a shell company (LLC or Corporation) serve as the GP of an LP.

Limited Liability Companies

The management of a limited liability company offers a bit more flexibility than partnerships do. The owners of an LLC are referred to as members and the members make the decisions about who will manage the LLC.

Generally speaking, there are two basic choices:

1. The default LLC law states that management of the LLC will be carried out with the consent of all members. In other words, the members manage the LLC. This structure is referred to as "member managed." The individual responsibilities of members are spelled out in the operating agreement.
2. Alternatively, the members may jointly decide to appoint someone to manage the business. They may choose one of the members, or they may elect to hire an outside manager. In either case, this options is referred to as "manager managed."

The benefit of appointing a manager is that it allows for better control over the business than having all members share management responsibilities. It also provides for the possibility that some members may wish to take a passive role. The manager managed structure is the preferred management structure.

Members also have the option, which has become popular in recent years, to have multiple managers serve in the capacity of a Board of Managers and then to have the Board of Managers designate officers to manage the LLC on a daily basis.

Corporations

Corporations have the most complicated management structure. Small corporations may simplify the structure to some degree, but there are some basic requirements:

1. Every corporation must have a board of directors. As a rule, the board is voted in by the shareholders and has the responsibility of selecting officers and making decisions in the best interest of the corporation.
2. The number of officers may vary from corporation to corporation, but as stated above, the officers are voted in by the board and may only be removed by the board. The officers typically include:
   - The President carries the majority of the management responsibility and reports directly to the Board of Directors. He is the person who has the authority to negotiate and sign contracts on behalf of the corporation, and to sign any legal documents.
   - The Vice President is often the first in line of succession in the event the President leaves. He is also responsible for a significant portion of the management responsibilities of the corporation. Companies may have many Vice Presidents.
   - The Secretary is responsible for maintaining the corporate records and books. This title may be held on its own or in conjunction with another title.
   - The Treasurer is responsible for account operations, financial records and transactions of the corporation.

It is not unusual for small corporations to assign the roles of Secretary and Treasurer to the same person. Some corporations may also choose to appoint a Chief Executive Officer, a Chief Financial Officer and other executives.

Pros and Cons of Each Structure

Each one of these entities may be appropriate for some real estate investors. It is important to understand the pros and cons of each entity structure and how it relates to your unique circumstances prior to forming an entity. The appropriate structure for real estate investors should also involve the accountant for the real estate investors. It is important that the entire team, legal and accounting, is on board with the best structure.

Let's look at the pros and cons of each potential entity.

Limited partnerships are simple to set up and may be ideal for passive real estate investors. The benefits are:

- Limited partners have limited liability and provides protection from litigation. If a limited partner is sued, the assets owned by the LP are protected. Conversely, if the LP is sued, the limited partners can be protected from liability;
- General partners handle the day-to-day running of the business;
- Unless one or more of the general partners collude or act directly in opposition to the partnership's best interests, they are not liable for the individual actions of other partners;
- The LP agreement is typically a privately signed document (it usually is not recorded or available to the public) and allows for anonymity if desired;
- Pass-through taxation benefits (profits are reported on the partners' personal tax returns); and
- Forming a LP assists with establishing credibility for the business.

However, there are a few drawbacks to the LP for real estate investors:

- Limited partners have little to no say in the running of the business or the use of property and other assets.
- The GP is liable for the acts of the limited partnership.

The limited partners may benefit from the LP structure because it limits their personal liability. A LP is a good structure for people who don't mind not having control over their investments.

Limited liability partnerships are very similar to limited partnerships. The primary difference is in the liability assigned to general partners.

- Partners are shielded from liability for the misconduct of other partners.
- LPs can generate capital investments by adding more limited partners.
- LLP is a pass-through entity and the LLP's income and losses are passed through to the partners, who then report it on their personal tax return.

The drawbacks to an LLC are:

- Limited partners have little to no control over the daily running of the business.
- In some states, LLPs may only be formed for the purposes of practicing a licensed profession (ex: law firm, architecture firm and accounting firms).

The limited liability limited partnership are used by far most often in the real estate industry when a group of investors get together and build a project such as a hotel, apartment community or commercial building. The investors are often more satisfied knowing they are not liable for the partnership's debt and can only lose what they invested, whereas the would-have-been general partner that organized the project gets the same peace of mind now that he is shielded.

The benefits of a LLLP are:

- Unlike a LP. the general partner of a LLLP are not personally responsible for the debts incurred by the partnership unless he agrees to be through debt covenants or other contracts. In spite of this, given the relative newness of LLLP, it is recommended that the general partner still be a shell company (LLC or Corporation) for an LLLP.
- The LLLP offers the opportunity for all partners to have some peace of mind when it comes to their liability for the financial obligations and debts of the partnership.
- LLLP is a pass-through entity and the LLLP's income and losses are passed through to the partners, who then report it on their personal tax return.

The drawbacks of a LLLP include:

- Despite offering liability protection for all members, business structures such as corporations and limited liability companies still offer more comprehensive protection.
- Limited partners are still limited in terms of their ability to control the partnership itself.

The limited liability company offers a degree of control and security that is not possible with any form of partnership. Here are the primary benefits of forming an LLC:

- LLC have great flexibility. The flexibility evolves from the phrase "unless otherwise provided for in the operating agreement." This allows business owners to create a structure tailored to the business owner's requirements.
- All members have limited liability, usually commensurate with their investment in the entity.
- A member's contributions may be money, property, services rendered or even a promise to deliver one or more of these things at a future date.

- As a rule, all members have some say in big decisions about the entity, usually in the form of weighted voting based upon their investment.
- An LLC can choose whether it wants to be taxed as a sole proprietorship, partnership, S corporation or corporation.
- Much like a limited partnership, members of an LLC can be investors only and have little or no say in the daily operation decisions of the business, as long as this is stated in the operating agreement.

There are, of course, some downsides of LLCs:

- If the LLC is member managed, any one member manager may negotiate and form contracts on behalf of the entity, which can leave the other members vulnerable in the event of a poorly negotiated contract or unreasonable financial obligation.
- The lack of strict requirements for governing the business could mean problems down the road unless a detailed operating agreement is in place.

Corporations offer some advantages to real estate investors. Primarily, the advantages are:

- It allows shareholders to hold themselves separate from the corporation, meaning that they have no personal liability for the financial debts and obligations of the corporation.
- Corporations exist in perpetuity, this is an advantage over a partnership or sole proprietorship, which cease to exist on the death of the owner.
- The corporate structure is such that all management is handled by board-designated officers who may or may not be shareholders of the company. Individual shareholders who are not officers may not bind the corporation or its shareholders to any contracts, financial or legal obligations.
- Shares and ownership may be transferred with relative ease compared to the requirements for partnerships – however this is typically governed by a Shareholder Agreement.
- Capital gains taxes will be higher upon the sale of the real estate.
- Real estate can never be transferred out of a corporation to its shareholders tax free.

The centralized management and liability protection of a corporation are its biggest benefits for real estate investor. It should be noted, though, that there are a few potential downsides of forming a corporation:

- Double taxation with the corporation paying taxes on income of the corporation and then shareholders paying taxes on dividend income they receive.

- Real estate investors often form corporation with just one or two people, all of whom are officers. In such a case, the officers may sometimes take actions that threaten the corporate veil. For example, any intermingling of personal and corporate assets may give a debtor or interested party an argument that the corporation is not valid.
- Unless you follow corporate formalities, the liability protection for which many people form corporations will be disregarded. The formalities include holding shareholder meetings, holding board meetings, keeping corporate records, and treating the corporation as a distinct and separate entity.
- Likewise, any officer or shareholder who makes illegal or unethical commitments on the part of the corporation may likewise endanger the other shareholders.
- Any shareholder or officer who signs a personal guaranty may still be personally liable for financial obligations as outlined in the guaranty.
- Sometimes the corporate structure can save on taxes, sometimes it can cost more. Taxation is a complicated issue, and depending on the amount of income, the type of corporation (whether is an “S” or “C” corporation, which refers to how it is taxed), and the other financial situations of the shareholders, the corporate structure can be beneficial or detrimental.

These are significant risks, but they may largely be overcome by designating non-shareholders as officers of the company. This arrangement prevents individual shareholders from encumbering other shareholders while still giving them the opportunity to vote on key matters at shareholders’ meetings.

Land Trust

We would be remiss if we didn’t mention the land trust as an option to hold real estate.

The land trust is one of the most talked about, but least understood, tools utilized by real estate investors. The land trust, contrary to the multiple internet gurus or guest REIA speakers is simply and nothing more than a title holding vehicle with some interesting attributes. From a legal standpoint, the land trust is a type of “grantor trust”. There are many types of grantor trusts, including living trusts and personal property trusts, all with generally the same purpose: to shift the title of property out of your name and into the care of a trustee.

A land trust can be used in just about any real estate transaction; but for most real estate investors, it is commonly used for the following purposes:

- Avoiding the due on sale clause when encumbered property is transferred;
- Providing privacy of ownership;
- Avoiding county transfer taxes; and
- Wholesaling property or purchasing property subject to an existing loan.

The parties to a land trust are:

- *The Grantor*: This person sets up the trust and transfers assets into the trust.
- *The Trustee*: The person who manages the trust. The trustee should have actual duties so the trust isn't a passive trust. However, the grantor can name himself trustee if he wants to, but use of another person in this role could be recommended in certain circumstances. Of course you must trust that person.
- *The Beneficiary*: The beneficiary is usually the grantor—he gets the "beneficial interest", i.e. ownership, of the trust. Think of this like stock in a corporation. It is personal property and has all of the ownership rights associated therewith. This will also be covered later.

The disadvantages to a land trust are:

- Little protection to offset litigation or taxes;
- Not recognized by statute in many states;
- The trustee does not need to perform any duties; and
- The land trust could enable fraud.

Canadian Investors

A few words for our friends north of the border. Canadian investors seeking to avoid the onerous 'double taxation' problem of using an LLC to hold their U.S. investment property will certainly want to and need to consider the LP as a strategic entity for doing business. They receive significant asset protection, they can use a Canadian or US shell company as the general partner, and the issues of the real estate professional classification are irrelevant as they file under Canada tax law.

Conclusion

The key to choosing the right entity to protect any real estate investment is to weigh the benefits and legal protections of each entity against the risks. A decision should be made in consultation with the real estate investor's team, including the accountant. Practically speaking, the LP and LLC are the most often used entity structures used by real estate investors.

While this white paper discussed corporations and the advantages, disadvantages and formation process for corporations, for most real estate investors, the use of a corporation (or a limited liability company taxed as an S-corporation) for holding real estate should not be considered due to significant potential tax consequences. Those tax consequences are beyond the scope of this white paper, but if you are a real estate investor considering holding real estate in a corporation and you have not been advised by your accountant or attorney of the potential tax consequences of doing so, I would advise you to seek out a new accountant or attorney.

While the process of making real estate investments may change over time, the bottom line is that any investment you make should be structured in such a way that your financial investment—as well as the investment of your time, expertise and labor—is protected.

Getting in touch with us

If you have any legal questions for Jason regarding the formation of an entity or investing questions for Abhi, get in touch with them!

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