

Matching Real Estate Investor with Business Entity

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Exhibit 1: COLA Fact Sheet, Social Security Administration

Exhibit 2: Form 2553 – Election by a Small Business Corporation

Exhibit 3: Form 8832 – Entity Classification Election

I. Real Estate Investor Strategies

Real estate is a versatile field. There are many, many ways an investor can make money in real estate. I recently attended a real estate investor summit where a speaker outlined a full fourteen different strategies over the course of an hour. While the possibilities are numerous, in my practice the most common strategies I've seen investors use are:

- A. Buy and Hold – includes rentals but can also include other ventures such as self-storage. An investor will purchase a property and hold it for a number of years while collecting rent and eventually recognize gain when the property is sold.
- B. Fix and Flip – the investor purchases a distressed property and after making improvements (cosmetic or substantive) the investor will sell the property to a new buyer.
- C. Wholesaling – structured one of several ways. In the first permutation, an investor may enter into a purchase agreement using a trust or LLC and then the investor assigns the beneficial interest in the trust to the ultimate purchaser or sells the LLC to the purchaser. In the second potential structure, the purchase agreement may be simply assigned to the ultimate purchaser.
- D. Real Estate Agent/Brokerage – the individual is a licensed real estate agent, representing and assisting buyers and sellers in closing on properties.

II. Self-Employment Tax Primer

A quick word on self-employment tax. When discussing self-employment tax, the Tax Code is drafted in very broad terms.¹ Distilling down the provisions of the Code, the IRS explains that you are considered self-employed if any of the following are true:

- 1) You carry on a trade or business as a sole proprietor or an independent contractor;
- 2) You are a member of a partnership that carries on a trade or business;
- 3) You are otherwise in business for yourself (including a part-time business).²

If investors don't fall into category one or two above, they most certainly will be considered self-employed under category three because the language is so broad.

Why does it matter? A self-employed individual generally must pay self-employment tax as well as income tax. Self-employment tax is a Social Security and Medicare tax levied on individuals who work for themselves.

When an employee (by definition not self-employed) earns income in 2017, the employer's payroll service withholds 7.65%, representing the tax levied on the employee for Social Security (6.2%) and Medicare (1.45%). The employer then pays an additional 7.65%. Thus, in total the employee/employer each covers half of the 15.3% tax levied for Social Security and Medicare.³

¹ See 26 U.S.C. § 1401

² <https://www.irs.gov/individuals/self-employed> (last retrieved 5/30/2017)

³ See COLA Fact Sheet, Social Security Administration – Enclosed as Exhibit 1

When an individual is self-employed, they must act as both the employee and the employer.⁴

Investors, by definition, are always keen to improve their bottom line. There is a strategy to minimize the exposure to self-employment tax by using an S-Corporation or LLC taxed as an S-Corporation but first you must decide whether the structuring is necessary.

First, rental real estate is considered a per se passive activity and therefore generates passive income.⁵ Because rent is considered passive, it typically is not subject to self-employment tax and so the buy and hold investment strategy does not generate a self-employment tax concern under most circumstances (there are exceptions to this general rule, however, for hotels, beds and breakfasts, dealers in real estate, and others).⁶ The corresponding tax strategy, therefore, will not use an S-Corporation (more later).

Second, the full amount of self-employment tax (the 15.3% discussed above) is only assessed on a taxpayer's first \$127,200 of earnings.⁷ After the taxpayer has earned \$127,200 the social security portion is no longer assessed and only the Medicare portion (1.45%) is assessed. Therefore, individuals who work full-time or part-time jobs in addition to their real estate investing may not benefit from structuring to minimize self-employment tax because the law is drafted in such a way that the lion's share (12.4%) of the tax assessment phases out due to the amount of income they receive from their employment in other activities.

Assuming, however, that the investor is not otherwise employed part-time or full-time and is seeking opportunity outside of buy and holds, the tax strategy of choice will generally be one that will minimize self-employment tax. An excellent tool can be the use of S-Corporation but more on that below in Section III(C)(2)(b).

III. Entity Primer – What Entities Are Available For Use?

In choosing the proper business entity for a particular situation, two parallel considerations must be taken into account: 1) Asset Protection and 2) Tax Planning. Due to the treatment of certain entities under state law for asset protection purposes, the entities I utilize the most often boil down to roughly just a few variations. What follows in this section will be a brief review of applicable asset protection considerations as well as the tax planning considerations for each type of entity. See below, in section IV for the most commonly used structures if you wish to get right to the recommendations.

A. Sole Proprietorship

1. Asset Protection

A sole proprietorship is, according to the Colorado Secretary of State, not a recognized form of business entity. Instead it is an individual engaged in a business activity. The Colorado Revised Statutes, in defining a "domestic entity" and "foreign entity," make no reference at all to a sole proprietorship and as a result sole proprietorships cannot avail themselves of the protections and other provisions

⁴ 26 U.S.C. § 1401

⁵ 26 U.S.C. § 469(c)(2)

⁶ See IRS Publication 527

⁷ See COLA Fact Sheet, Social Security Administration – Enclosed as Exhibit 1

afforded to other types of business entities under applicable Colorado Statutes.⁸ As such, the sole proprietorship does not provide for strong asset protection and should only be used sparingly for investors who do not yet know how much time or effort they will expend in investing and would prefer a more flexible set up at the cost of less asset protection.

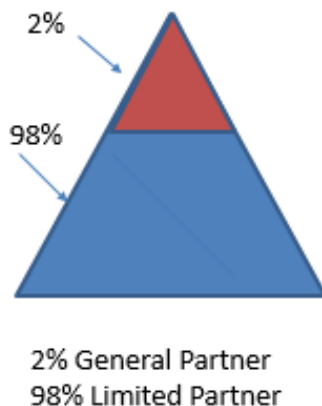
2. Tax Planning

The sole proprietorship is the least formal of all options. It can be a good fit for those just starting out as the lack of formality can be desirable for those who are overwhelmed with starting a new venture or are simply unsure of how much profit they'll realize and time they may commit. The sole proprietorship is considered a pass-through tax scenario in that all tax implications (income, deductions, credits, etc.) will be reflected on an individual's personal tax return (Form 1040 and its related schedules and forms). Many individuals prefer this simplicity, however there are disadvantages. First, tax planning opportunities are limited on the Form 1040. Second, the IRS audits continual losses on Schedule C and so there could be a higher risk for audit if a taxpayer reports a loss year after year. Finally, there is no opportunity to limit exposure to self-employment tax and as a result other tax scenarios will often be more beneficial to those who are facing potential self-employment tax exposure.

B. Partnership

1. Asset Protection

A Limited Liability Partnership is relatively strong for asset protection purposes and should always be favored over a General Partnership.⁹ The governance of a Limited Liability Partnership can be summarized visually as follows:



There are two types of Partners in a Limited Liability Partnership, the General Partner and the Limited Partner. Management is reserved to the General Manager while Limited Partners do not share in the management decisions or responsibilities of the company. Because of their limited involvement, the Limited Partners receive the benefit of asset protection because the liabilities of the Partnership will

⁸ See C.R.S. § 7-90-102 (13) and (23)

⁹ See C.R.S. § 7-64-302(1) providing for joint and several liability for Partners in a General Partnership.

not be extended to the Limited Partners in their personal capacities.¹⁰ The General Partner, on the other hand, does not automatically enjoy the limited liability protection afforded by the structure as significant exceptions can be found in the statutes to allow creditors to reach the assets of a General Partner.¹¹ Therefore, it is common to see the General Partner holding a mere 1% or 2% of the ownership interest in the Company to limit their potential exposure. A common structure may be for a husband and wife each to be both General Partners and Limited Partners. Each would hold 1% as a General Partner and each would hold also 49% as a limited partner. The 49% each hold would be protected but the 1% each holds in their capacity as General Partner could potentially be easily reached by a creditor. Due to this potential greater avenue for General Partner liability, the LLC is a better choice in most circumstances because it will shield the owner completely.

2. Tax Planning

Partnerships file their own tax return with the IRS (Form 1065). Though the partnership prepares and files this return, the operation of the return is such that all income, deductions, credits, etc. are all passed through to the partners via a form K-1 (which is entered by the partner on Schedule E to the 1040). As a result, the partnership itself does not pay tax – instead the partners pay the tax on income earned at their own respective tax rates and with reference to their own personal deductions, credits, phaseouts, etc. This flow-through nature of the partnership can be very desirable for two reasons: 1) losses from a partnership can offset income from other activities on the Form 1040, and 2) tax is paid on income only once at the partner level. There is no potential for limiting self-employment tax using a Partnership, however, so the partnership should be limited in use to those activities that do not generate self-employment tax exposure.

C. Corporation

1. Asset Protection

Corporations are some of the strongest entities that can be used for asset protection purposes. They are protected as legal entities separate and distinct from their owners and thus create a “corporate veil” between the company and its activity and the shareholders and their assets.¹²

A great example of the corporate veil is illustrated by Samsung and their (fairly) recent cellphone fires. If a consumer were to sue the company, they do not have a cause of action against each and every shareholder in the company. Instead, they have a cause of action against the company only. The assets of the company may be at risk but each shareholder’s assets should remain relatively safe from collection efforts. Shareholder liability is typically limited only to the amount of money they have invested in the company.

Governance is briefly summarized as follows: the shareholders are the ultimate authority in the company. The shareholders vote and elect a board of directors who are in charge of the operation of the Company. The board of directors then elect officers (President, VP, Secretary, Treasurer, etc.) to

¹⁰ C.R.S. § 7-64-302(3) and (4)

¹¹ See, e.g., C.R.S. § 7-64-305(1) and (2); C.R.S. § 7-64-306(3)

¹² See, e.g., *Leonard v. McMorris*, 63 P.3d 323, 330 (Colo. 2003); *Contractors Heating & Supply Co. v. Scherb*, 163 Colo. 584, 587-88, 432 P.2d 237, 239 (1967).

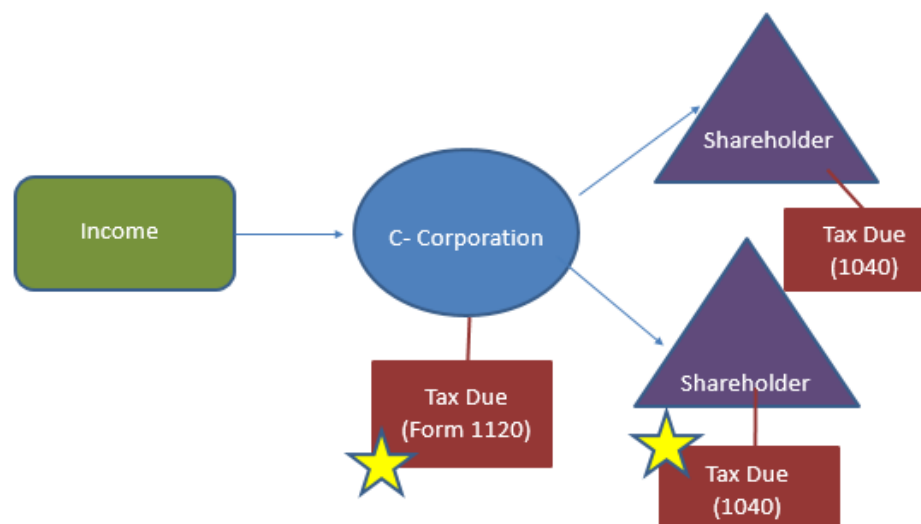
manage the day-to-day operations of the company. The officers are answerable to the board of directors who, in turn, are answerable to the shareholders.

2. Tax Planning

The Tax Code allows corporations to be taxed one of two ways. A corporation can be taxed as a C-Corporation or it can be taxed as an S-Corporation. The names are taken from the subchapter of the Tax Code where the statutes governing their taxation can be found.¹³ The best example of C-Corporations, generally speaking, are large, publicly traded companies on the stock exchange. S-Corporations, on the other hand, potentially limit self-employment tax exposure and so are the tax method of choice for independent contractors, fix and flippers, doctors, lawyers, and other professionals.

a. C-Corporation

A newly formed Corporation will be treated by the IRS as a C-Corporation by default.¹⁴ This is often not desirable because of how a C-Corporation is taxed. Visually the C-Corporation tax scenario looks like this:



To summarize the above graphic, income flows into the Corporation. The Corporation will file its own return (Form 1120) and reflect all income, deductions, credits, etc. on its return. The tax return, on Line 34, calculates an “Amount Owed.” In other words, the Corporation itself will pay tax (represented by the star in the middle of the graphic).

The shareholders then receive compensation from the company (be it in the form of a salary if they are also an employee or dividends if they are a mere investor in the company, or both). The individual, then, will include the compensation in their own calculation of tax owed on their individual Form 1040 (represented by the star on the right). Thus, the C-Corporation suffers from a problem called “double taxation” in that the same income is taxed twice – once at the corporate level and again at the shareholder level. The double taxation of income should disqualify the C-Corporation from

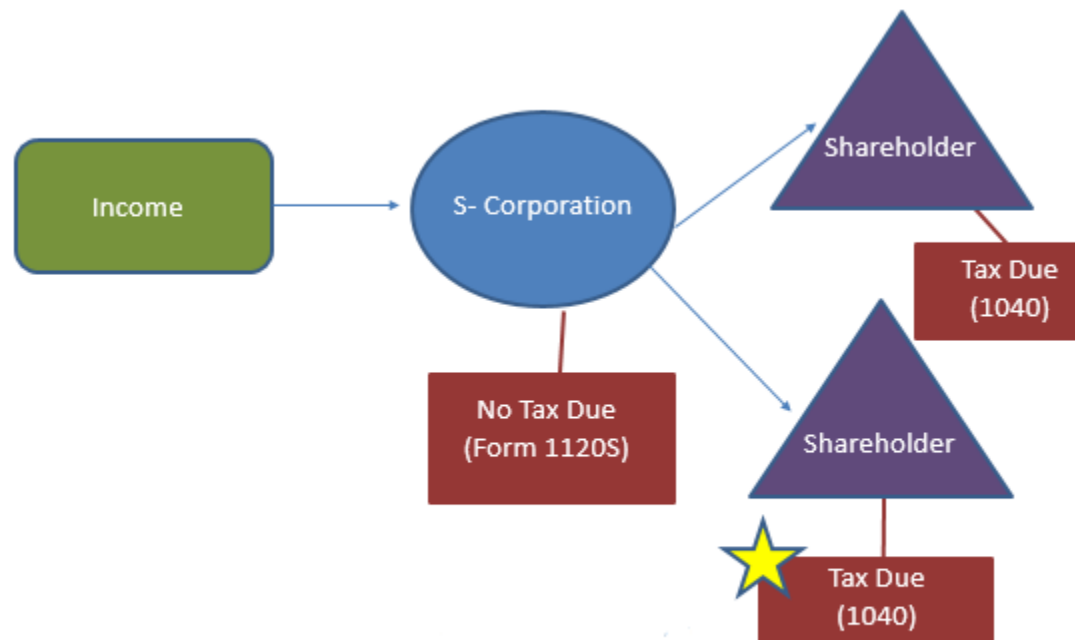
¹³ See Title 26 of the US Code, Subtitle A, Chapter 1, Subchapter C for C-Corporations; See Title 26 Of the US Code, Subtitle A, Chapter 1, Subchapter S for S-Corporations.

¹⁴ See 26 C.F.R. §§ 301.7701-2 & 301.7701-3.

consideration in all but very limited circumstances. Additionally, long-term capital gain does not exist for a C-Corporation and so buy and hold real estate should never be held in a C-Corporation.¹⁵

b. S-Corporation

The S-Corporation does not suffer from the double taxation problem of the C-Corporation because it is a flow-through entity. In other words there is no tax paid at the corporate level. Visually, this can be represented as follows:



Compared to the C-Corporation graphic above, there is only star representing that tax is paid only once at the shareholder level which illustrates the lack of the double taxation problem. The company still is required to prepare and file its own annual return (Form 1120S) but no tax is due as a result of the calculations on that form. Instead, all implications are passed through to the shareholders via Schedule K-1 and inputted into the shareholder's Schedule E and various other places.

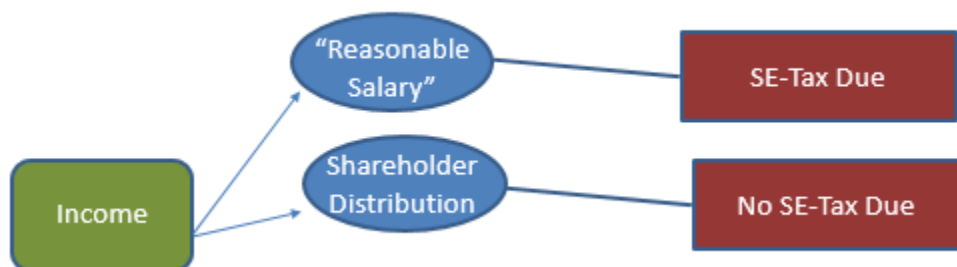
There is an additional wrinkle to the S-Corporation. As discussed above in Section II, self-employment tax may apply to those individuals who have not yet earned \$127,200 in 2017 and are "in business for themselves." The S-corporation is the answer to limiting exposure to self-employment tax.

Compensation from an S-Corporation to a shareholder should be paid in two ways. First, the IRS requires that a shareholder employee (defined generally as anyone providing services to the Corporation beyond mere passive investment) pay themselves a "reasonable salary."¹⁶ The amount paid

¹⁵ See 26 U.S.C. § 1(h)(9) and (10); 26 U.S.C. § 11

¹⁶ See 26 U.S.C. § 162(a)(1); 26 U.S.C. § 1366(e); Beiner Inc. v. Commissioner, T.C. Memo 2004-219

as the reasonable salary is subject to self-employment tax. Any compensation that may be paid to a shareholder in excess of the reasonable salary may be paid as a shareholder distribution which is not subject to self-employment tax. Visually, the distinction can be represented like this:



The planning opportunity, therefore, is to channel as much income as possible to a shareholder distribution and pay no more than necessary as the reasonable salary. So how does one determine what is a reasonable salary?

Reasonable salary is a term of art. And though the word *reasonable* conjures feelings of subjectivity, the Tax Court has attempted to make the inquiry as objective as possible. The Courts have focused on the following 5-factors¹⁷ to determine what a reasonable salary should be (Factors are underlined, additional commentary is mine):

1. The Employee's Role in the Company: A CEO's salary should reflect the fact that the individual is a CEO. If they are a CEO and a CFO, a larger salary is likely required. If the individual is merely a consultant and leaves day-to-day operations to others, a CEO salary is likely not reasonable.
2. A Comparison of the Compensation Paid to the Employee with the Compensation Paid to Similarly Situated Employees in Similar Companies: If you are a CEO, then what does a CEO in a similarly sized company, with similar revenue, in a similar geographic region command as a salary?
3. The Character and Condition of the Company: Is the success or relative failure of the company due to your own efforts? Is the real estate market, for instance, in a downward turn and no effort of your own would impact the success of the company? Is the real estate market exploding and your relative success is not related to your own efforts? All of these factors may compel upward or downward adjustments to your salary.
4. Whether a Conflict of Interest Existed that May Have Permitted the Company to Disguise Dividend Payments as Deductible Compensation: Could you be hired and paid for services that you did not actually provide? Document negotiations for hiring decisions as well as salary negotiations, even if you are negotiating with your own family or close friends.

¹⁷ See, e.g., Beiner Inc. v. Commissioner, T.C. Memo 2004-219; Watson V. Commissioner, 668 F.3d 1008 (8th Cir., 2012); McAlary v. Commissioner, TC Summary Opinion 2013-62 (non-precedential); Glass Blocks Unlimited v. Commissioner, T.C. Memo 2013-180.

5. Whether the Company's Payments of Compensation to All of its Employees Were Internally Consistent: Does the CEO make the same amount of money as a janitor?

Potential drawbacks of the S-Corporation involve the relative headache and cost of ongoing compliance as well as limitations on who can own shares in an S-Corporation. Because the shareholder receives a salary, the shareholder must partner with a competent payroll service who can assist in withholding tax from wages, complete quarterly and annual filings with the IRS (Forms 941 and 940), and also complete necessary filings with the Colorado Department of Labor and Employment (frequency is based upon volume of wages).

In addition, there are limitations to those who can own shares in an S-Corporation. For instance, the following cannot own an interest in an S-Corporation:¹⁸

- 1) Partnerships
- 2) Non-Resident Aliens
- 3) Trusts & Estates
- 4) C-Corporations

Finally, there can be no more than one class of stock in an S-Corporation and there can be no more than 100 shareholders.¹⁹ If an ineligible person or entity obtains ownership in an S-Corporation or the number of shareholders exceeds 100, the IRS will terminate the S-election and the company will revert back to C-Corporation status.

S-Corporations, despite their benefits, are much more prone to present compliance issues for clients. Quarterly filings and reasonable salaries, in addition to the "normal" corporate formalities provide many avenues for challenge generally and also particularly at IRS audit. The desirability of an S-Corporation and its related benefits should be weighed against the investor's understanding of the tax implications and confidence that they can remain compliant. Also, a certain level of net income should be reached or projected with some certainty to ensure that the potential tax benefit outweighs the cost of the payroll service, tax return preparation, and other compliance items.

D. Limited Liability Company

1. Asset Protection

The Limited Liability Company largely provides the best of all worlds from an asset protection and tax planning standpoint though, as explored below, single-member LLC should be used carefully in order to avoid certain asset protection concerns.

a. Single-Member LLC

¹⁸ With the exception of certain trusts or estates that make timely elections. For instance, a trust can elect to be treated as an ESBT or a QSST or an estate can elect to hold the shares until the probate process is completed. See, e.g., 26 USC § 1361(c)(2).

¹⁹ 26 USC § 1361(b)(1).

An LLC, according to the Colorado Revised Statutes, may consist of only one Member.²⁰ This can be advantageous in that it does not require the solo investor to find a trustworthy business partner and does not require the time and expense of filing of a separate tax return.²¹

The Single-Member LLC, however, is potentially problematic and is not a tool that should be relied upon without additional planning. A 2003 bankruptcy case in the District of Colorado explored whether a bankruptcy trustee could force a single-member LLC to sell and distribute the proceeds of its real property holdings located within the State of Colorado.²²

Briefly summarized, the debtor was the only individual involved with the company (Western Blue Sky, LLC). The debtor acted as both Manager and Member. The LLC itself was not named in the bankruptcy pleadings and was not otherwise implicated in the bankruptcy proceedings.

The court reasoned that because the debtor was the only Member, the debtor's filing for bankruptcy assigned Debtor's LLC ownership interest to the bankruptcy estate and therefore the bankruptcy trustee obtained all of the debtor's rights in controlling and managing the affairs of the LLC. The court explicitly stated that the result would have been different if the LLC had other non-debtor Members.

This language is particularly enlightening: "In a single member entity, there are no non-debtor members to protect." Because there is only one individual involved in a single member LLC, the court reasoned that limiting potential collection avenues "serves no purpose in a single member limited liability company, because there are no other parties' interests affected."²³

The strictest reading of the Albright case may limit its applicability to the bankruptcy context but a prudent asset protection plan will weigh the potential applicability of this case to other contexts as well that may involve judgment creditors arising from tort claims, contract claims, and other potential claims real estate investors may face. Given the developments in the Albright case, along with potentially persuasive precedent arising out of Florida,²⁴ the uncertainty (at best) or limited utility (at worst) of the Single-Member LLC means that a strong asset protection plan will use them either sparingly, in conjunction with other stronger business entities, or not at all.

b. Multi-Member LLC

Colorado Statutes also allow a Limited Liability Company to be formed by multiple individuals.²⁵ Forming a Limited Liability Company with multiple owners effectively erases the concerns raised by the Albright case. The court in Albright specifically mentioned that the outcome would have been different if the company were comprised of more than one Member. Because an entity with multiple Members

²⁰ C.R.S. § 7-80-203 (1).

²¹ The default treatment of a single-member LLC under applicable Treasury Regulations is that a single-member LLC will be not recognized for tax purposes as an entity separate from its owner. A fancy way of saying that the LLC will be considered a "disregarded entity" for tax purposes. See 26 C.F.R. § 301.7701-3(a).

²² In re Ashley Albright, 291 B.R. 538 (Bankr. D. Colo. 2003).

²³ *Id.* at 541.

²⁴ See Federal Trade Commission v. Olmstead, 44 So. 3d 76 (Fla. 2010).

²⁵ C.R.S. § 7-80-203 (1).

effectively derails the line of the court's reasoning in Albright the use of a Multi-Member LLC is nearly always more desirable from an asset protection standpoint than the use of a Single-Member LLC.

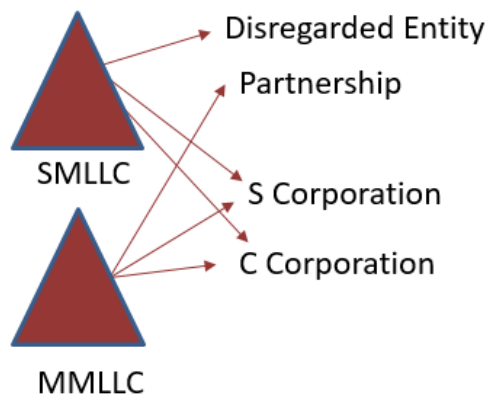
2. Tax Planning

The Limited Liability Company is an incredibly flexible tax planning tool. The Tax Code was enacted in 1986. Limited Liability Companies, however, are largely a creature of the early 1990s when states began drafting statutes to allow their use. Despite the advent of Limited Liability Companies after the drafting of the Tax Code, the Tax Code was not scrapped and rewritten after the fact. Instead, the Tax Code and applicable Treasury Regulations are drafted to allow the individuals forming a Limited Liability Company to effectively shoe-horn their new entity into the existing tax categories (e.g., Sole Proprietor, Partnership, C-Corporation, S-Corporation) within the bounds of a few rules. In essence, an LLC can notify the IRS how it would like to be treated for tax purposes.

If a Single-Member LLC is formed under state law, the IRS will classify it as a “disregarded entity” by default.²⁶ A disregarded entity is simply an entity that the IRS does not recognize for tax purposes meaning that all income, deductions, credits, etc. will flow through to and be reflected on the owner's personal tax return (Form 1040 and its related schedules and forms). A Single-Member LLC may also elect to be treated for tax purposes as an S-Corporation (by filing Form 2553) or C-Corporation (by filing Form 8832)²⁷. To be clear, for state law and asset protection purposes the company will be treated as a Single-Member Limited Liability Company and so making an election for the company to be treated one way or the other for tax purposes does not side-step the asset protection issue raised by the Albright court.²⁸ The tax elections merely represent a choice made concerning tax treatment and how the IRS views the company and its obligations.

If a Multi-Member LLC is formed under state law, the IRS will classify it as a partnership by default. The entity, therefore, will need to file Form 1065 along with its associated schedules and forms by the due date for the partnership return. A Multi-Member LLC may also elect to be treated for tax purposes as an S-Corporation or a C-Corporation by filing Forms 2553 or 8832, respectively.

To visually summarize the possibilities for the tax treatment of LLCs:



²⁶ 26 C.F.R. § 301.7701-3(a).

²⁷ Both forms are enclosed as Exhibits 2 and 3.

²⁸ In re Ashley Albright, 291 B.R. 538 (Bankr. D. Colo. 2003).

E. Trusts

1. Asset Protection

There are many who would use Trusts for asset protection purposes. While there are structures that can be used, often they are very complicated and some practitioners I've met extol the virtues of even going offshore. To me, creating the complicated structure necessary creates too many potential compliance issues and I advise clients to keep things simpler by using a well-formed and well-managed business entity such as an LLC or Corporation. In addition, issues with control over or receiving the benefit of assets are often raised.

As a general background, there are three individuals involved with a trust: 1) the settlor, or the one who creates the trust; 2) the trustee, the individual or entity who holds legal title to the trust assets for the benefit of the beneficiaries; and 3) the beneficiary(ies), or the individuals who hold equitable title to the trust assets and for whom the trust was created. In order to defeat claims for creditor recovery from trust assets, the settlor cannot retain too much control nor can the settlor retain too much of a beneficial interest in the assets of the trust.²⁹ When advising clients of these principals, the business entity tends to interest clients more as they can retain more control as well as benefit more from the trust assets while still enjoying limited liability.

Further, there are two types of trusts: irrevocable trusts and revocable trusts. Revocable trusts are often used in the estate planning context but do not give very strong asset protection as they can be revoked at any time while the settlor is still alive. Therefore, a trust that provides for asset protection should be an irrevocable trust which are very difficult to modify compared to an LLC's operating agreement, for example. On the whole, when clients are faced with the choice between an inflexible set up involving an irrevocable trust that they cannot maintain too much control over or benefit too much from, clients choose a business entity (LLC or Corporation) instead.

2. Tax Planning

A revocable trust may be considered a grantor trust under the Tax Code.³⁰ Much like a disregarded entity, the income, deductions, credits, etc. all are reflected on the settlor's tax return rather than a dedicated trust return. The grantor trust, however, lacks much of the formality and the irrevocable nature that is required for asset protection.

When a trust is compelled to file its own tax return (ie, it does not qualify as a grantor trust) it must file Form 1041. For tax purposes, a trust can be a simple trust or it can be a complex trust. A simple trust must distribute its income annually to the beneficiaries.³¹ The end result is that the beneficiaries must reflect the income on their own tax returns and pay the tax due. A complex trust, on the other hand, may accumulate trust income and may pay tax at the trust level.³² For clients who do not wish to burden potential beneficiaries with tax implications (or distribute assets too early) the complex trust will likely be the preferable trust.

²⁹ See, e.g., Matter of Estate of Kovalyshyn, 343 A.2d 852 (N.J. Co. Prob. Div. 1975).

³⁰ See, e.g., 26 USC § 671-679.

³¹ 26 U.S.C. § 651

³² 26 U.S.C. § 661

Though the complex trust allows assets to accumulate within the trust, trust tax rates are relatively compressed. A complex trust that files Form 1041 will likely generate a larger tax bill than a business entity that flows through to a personal tax return. Compare, for instance, the personal tax rate to the trust tax rate for 2017:

| | *** | | | | | *** | | | |
|---------|---------------------------------|-----------------|----------------------|--------------------------|-------|---------------------------------|-----------------|--------------------|--------------------------|
| | If Taxable Income is Over | But Not Over | The Tax Is | Of the Amount Over | | If Taxable Income is Over | But Not Over | The Tax Is | Of the Amount Over |
| Married | \$0 | \$18,650 | \$0.00 + 10% | \$0 | Trust | \$0 | \$2,550 | 0.00 + 15% | \$0 |
| Filing | \$18,650 | \$75,900 | \$1,865.00 + 15% | \$18,650 | | \$2,550 | \$6,000 | 382.50 + 25% | \$2,550 |
| Joint | \$75,900 | \$153,100 | \$10,452.50 + 25% | \$75,900 | | \$6,000 | \$9,150 | \$1,245.00 + 28% | \$6,000 |
| | \$153,100 | \$233,350 | \$29,752.50 + 28% | \$153,100 | | \$9,150 | \$12,500 | \$2127.00 + 33% | \$9,150 |
| | \$233,350 | \$416,700 | \$52,222.50 + 33% | \$233,350 | | \$12,500 | | \$3,232.50 + 39.6% | \$12,500 |
| | \$416,700 | \$470,700 | \$112,728.00 + 35% | \$416,700 | | | | | |
| | \$470,700 | | \$131,628.00 + 39.6% | \$470,700 | | | | | |

To summarize the information in the above chart, the top tax rate of 39.6% for married filing joint taxpayers will not apply until they earn \$470,700 of income. The top tax rate of 39.6%, however, applies at a much lower level of income for trusts, beginning at a mere \$12,500.

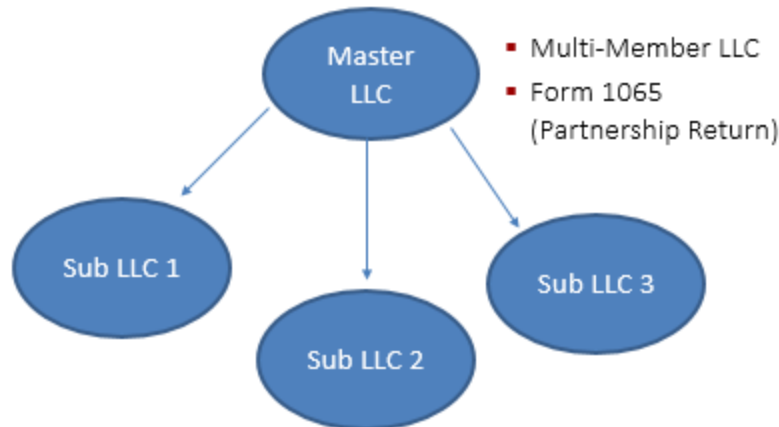
IV. Entity Structures Paired With Investor Strategy

Returning to the initial list of the most common activities real estate investors are using to earn a profit in Section I and in light of all items discussed above, a pairing of investing strategy with tax and asset protection strategy looks like this:

- A. Buy and Hold – Multi-Member LLC taxed as a partnership. Under most circumstances there is no exposure to self-employment tax from the rent payments or the long-term capital gain upon the sale of the property so there is no need for S-Corporation style planning. The Multi-Member component of the LLC structuring is necessary in light of the holding in Albright. If only one individual is investing, consider advising your client to find a bona-fide third party to partner with.

An investor with several buy and hold investments may also be well served to create a parent/subsidiary relationship whereby single-member LLCs are paired with a Multi-Member LLC taxed as a partnership. Each single-member LLC can hold title to one or several properties thereby effectively placing the investors “eggs in different baskets” while being tax-efficient because the entire structure will only file one tax return.³³ Visually, such a structure would look like this:

³³ Because each single-member LLC will be considered a disregarded entity for tax purposes, the income/deductions/credits, etc. will all flow through to the partnership return filed by the Multi-Member LLC taxed as a partnership.



- B. Fix and Flip – Sole shareholder S-Corporation if only one individual due to the Single-Member LLC issue identified with the holding in Albright. A stronger asset protection choice would be a Multi-Member LLC that elects to be treated as an S-Corporation or an S-Corporation with multiple shareholders. The individuals will be considered to be self-employed and so must pay self-employment tax. So long as they do not have part-time or full-time employment elsewhere (remember the threshold of \$127,200 in 2017) and will generate enough income to reap a large enough tax benefit to justify paying for the payroll company, quarterly filings (Form 941, etc), and annual tax return (1120S), the S-Corporation will be a good fit.
- C. Wholesaling – Sole shareholder S-Corporation if only one individual due to the Single-Member LLC issue identified with the holding in Albright. A stronger asset protection choice would be a Multi-Member LLC that elects to be treated as an S-Corporation or an S-Corporation with multiple shareholders. The individuals will be considered to be self-employed and so must pay self-employment tax. So long as they do not have part-time or full-time employment elsewhere (remember the threshold of \$127,200 in 2017) and will generate enough income to reap a large enough tax benefit to justify paying for the payroll company, quarterly filings (Form 941, etc), and annual tax return (1120S), the S-Corporation will be a good fit.
- D. Real Estate Agent/Brokerage – Sole shareholder S-Corporation if only one individual due to the Single-Member LLC issue identified with the holding in Albright. The individual will be considered to be self-employed and so must pay self-employment tax. So long as they do not have part-time or full-time employment elsewhere (remember the threshold of \$127,200 in 2017) and will generate enough income to reap a large enough tax benefit to justify paying for the payroll company, quarterly filings (Form 941, etc), and annual tax return (1120S), the S-Corporation will be a good fit.

V. Miscellaneous Considerations

- A. Minimum Formalities

All business entities, regardless of type, should be run with an eye to formality. Many is the client or investor who tells me that they have filed Articles of Organization with the Secretary of State, taken no further action, and expect that they will be protected when an issue arises.

Corporate or LLC formalities are critical to consider. Every Corporation should have Bylaws, every Limited Liability Company should have an Operating Agreement, and every Partnership should have a Partnership Agreement. The owners of the company should meet each year (if not more often) and chronicle their meetings using formal, written minutes. The company should obtain an EIN (employer identification number) and it should open its own, dedicated bank account. There should be no commingling of funds between the owners' personal accounts and the business account.

Adhering to and observing these formalities will give the company the appearance of more formality. A formal company is more likely to provide asset protection while an informal approach to company operations will be more likely to result in veil piercing and owner's personal assets being reached to satisfy creditors.³⁴

B. What State?

Many investors have heard sales pitches that involve out of state structures with companies located in Delaware, Wyoming, Nevada, other places, or a combination of all. Without touching upon multi-jurisdictional or unauthorized practice of law concerns, such an approach adds complications to the structure and may contribute to failures of the investor to keep the company structure in compliance.

Generally speaking, when real property is involved in litigation the law of the situs of the real estate will govern the law to be applied.³⁵ As a result, the investor who files abroad will not necessarily receive the benefit of the "more favorable law" by simply registering abroad.

C. Insurance

Ultimately, asset protection is more effective when it is treated as an approach with multiple layers. The entity structuring should be treated as one potential layer of protection but insurance should not be ignored.

Every business should consider a General Business Insurance policy. These policies typically cover specified risks from accidents that may occur on the business' premises and can even cover owners or employees who travel in the scope of their employment. Other personal liability insurance policies such as Automotive Insurance, Umbrella Insurance, and Homeowners Insurance should also be considered to potentially close gaps in coverage.

³⁴ See, e.g., *Leonard v. McMorris*, 63 P.3d 323, 330 (Colo. 2003); *Contractors Heating & Supply Co. v. Scherb*, 163 Colo. 584, 587-88, 432 P.2d 237, 239 (1967).

³⁵ See, e.g., *Restatement of Conflict of Laws* (Second) § 280.

Exhibit 1: 2017 COLA Fact Sheet, Social Security Administration



Fact Sheet

SOCIAL SECURITY

2017 SOCIAL SECURITY CHANGES

o **Cost-of-Living Adjustment (COLA):**

Based on the increase in the Consumer Price Index (CPI-W) from the third quarter of 2014 through the third quarter of 2016, Social Security and Supplemental Security Income (SSI) beneficiaries will receive a 0.3 percent COLA for 2017. Other important 2017 Social Security information is as follows:

| | <u>2016</u> | <u>2017</u> |
|---------------------------|-------------|-------------|
| o <u>Tax Rate:</u> | | |
| Employee | 7.65% | 7.65% |
| Self-Employed | 15.30% | 15.30% |

NOTE: The 7.65% tax rate is the combined rate for Social Security and Medicare. The Social Security portion (OASDI) is 6.20% on earnings up to the applicable taxable maximum amount (see below). The Medicare portion (HI) is 1.45% on all earnings. Also, as of January 2013, individuals with earned income of more than \$200,000 (\$250,000 for married couples filing jointly) pay an additional 0.9 percent in Medicare taxes. The tax rates shown above do not include the 0.9 percent.

o **Maximum Taxable Earnings:**

| | | |
|------------------------------|-----------|-----------|
| Social Security (OASDI only) | \$118,500 | \$127,200 |
| Medicare (HI only) | No Limit | |

o **Quarter of Coverage:**

| | |
|---------|---------|
| \$1,260 | \$1,300 |
|---------|---------|

o **Retirement Earnings Test Exempt Amounts:**

| | | |
|---------------------------|-------------------------------|-------------------------------|
| Under full retirement age | \$15,720/yr. (\$1,310/mo.) | \$16,920/yr. (\$1,410/mo.) |
|---------------------------|-------------------------------|-------------------------------|

NOTE: One dollar in benefits will be withheld for every \$2 in earnings above the limit.

| | | |
|--|-------------------------------|-------------------------------|
| The year an individual reaches full retirement age | \$41,880/yr. (\$3,490/mo.) | \$44,880/yr. (\$3,740/mo.) |
|--|-------------------------------|-------------------------------|

NOTE: Applies only to earnings for months prior to attaining full retirement age. One dollar in benefits will be withheld for every \$3 in earnings above the limit.

There is no limit on earnings beginning the month an individual attains full retirement age.

o **Social Security Disability Thresholds:**

Substantial Gainful Activity (SGA)

| | | |
|-------------------------|-------------|-------------|
| Non-Blind | \$1,130/mo. | \$1,170/mo. |
| Blind | \$1,820/mo. | \$1,950/mo. |
| Trial Work Period (TWP) | \$ 810/mo. | \$ 840/mo. |

o **Maximum Social Security Benefit: Worker Retiring at Full Retirement Age:**

| | | |
|--|-------------|-------------|
| | \$2,639/mo. | \$2,687/mo. |
|--|-------------|-------------|

o **SSI Federal Payment Standard:**

| | | |
|------------|-------------|-------------|
| Individual | \$ 733/mo. | \$ 735/mo. |
| Couple | \$1,100/mo. | \$1,103/mo. |

o **SSI Resources Limits:**

| | | |
|------------|---------|---------|
| Individual | \$2,000 | \$2,000 |
| Couple | \$3,000 | \$3,000 |

o **SSI Student Exclusion:**

| | | |
|---------------|---------|---------|
| Monthly limit | \$1,780 | \$1,790 |
| Annual limit | \$7,180 | \$7,200 |

o **Estimated Average Monthly Social Security Benefits Payable in January 2017:**

| | <u>Before 0.3% COLA</u> | <u>After 0.3% COLA</u> |
|---|------------------------------------|-----------------------------------|
| All Retired Workers | \$1,355 | \$1,360 |
| Aged Couple, Both Receiving Benefits | \$2,254 | \$2,260 |
| Widowed Mother and Two Children | \$2,686 | \$2,695 |
| Aged Widow(er) Alone | \$1,296 | \$1,300 |
| Disabled Worker, Spouse and One or More Children | \$1,990 | \$1,996 |
| All Disabled Workers | \$1,167 | \$1,171 |

Exhibit 2: Form 2553 – Election by a Small Business Corporation

Election by a Small Business Corporation
(Under section 1362 of the Internal Revenue Code)

▶ See Parts II and III on page 3.

▶ You can fax this form to the IRS (see separate instructions).

▶ Information about Form 2553 and its separate instructions is at www.irs.gov/form2553.

OMB No. 1545-0123

Note. This election to be an S corporation can be accepted only if all the tests are met under *Who May Elect* in the instructions, all shareholders have signed the consent statement, an officer has signed below, and the exact name and address of the corporation (entity) and other required form information have been provided.

Part I Election Information

| | | |
|----------------------|--|---|
| Type or Print | Name (see instructions) | A Employer identification number |
| | Number, street, and room or suite no. (If a P.O. box, see instructions.) | B Date incorporated |
| | City or town, state, and ZIP code | C State of incorporation |

D Check the applicable box(es) if the corporation (entity), after applying for the EIN shown in **A** above, changed its ☐ name or ☐ address

E Election is to be effective for tax year beginning (month, day, year) (see instructions) ▶ _____

Caution. A corporation (entity) making the election for its first tax year in existence will usually enter the beginning date of a short tax year that begins on a date other than January 1.

F Selected tax year:

- (1) ☐ Calendar year
 (2) ☐ Fiscal year ending (month and day) ▶ _____
 (3) ☐ 52-53-week year ending with reference to the month of December
 (4) ☐ 52-53-week year ending with reference to the month of ▶ _____

If box (2) or (4) is checked, complete Part II.

G If more than 100 shareholders are listed for item J (see page 2), check this box if treating members of a family as one shareholder results in no more than 100 shareholders (see test 2 under *Who May Elect* in the instructions) ▶ ☐

| | |
|--|--|
| H Name and title of officer or legal representative who the IRS may call for more information | I Telephone number of officer or legal representative |
|--|--|

If this S corporation election is being filed late, I declare that I had reasonable cause for not filing Form 2553 timely, and if this late election is being made by an entity eligible to elect to be treated as a corporation, I declare that I also had reasonable cause for not filing an entity classification election timely and that the representations listed in Part IV are true. See below for my explanation of the reasons the election or elections were not made on time and a description of my diligent actions to correct the mistake upon its discovery (see instructions).

Sign Here

Under penalties of perjury, I declare that I have examined this election, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete.



Signature of officer

Title

Date

Part I Election Information (continued) **Note.** If you need more rows, use additional copies of page 2.

| J Name and address of each shareholder or former shareholder required to consent to the election. (see instructions) | K Shareholder's Consent Statement Under penalties of perjury, I declare that I consent to the election of the above-named corporation (entity) to be an S corporation under section 1362(a) and that I have examined this consent statement, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I understand my consent is binding and may not be withdrawn after the corporation (entity) has made a valid election. If seeking relief for a late filed election, I also declare under penalties of perjury that I have reported my income on all affected returns consistent with the S corporation election for the year for which the election should have been filed (see beginning date entered on line E) and for all subsequent years. | | L Stock owned or percentage of ownership (see instructions) | | M Social security number or employer identification number (see instructions) | N Shareholder's tax year ends (month and day) |
|--|---|------|---|------------------|---|---|
| | Signature | Date | Number of shares or percentage of ownership | Date(s) acquired | | |
| | | | | | | |
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Part II Selection of Fiscal Tax Year (see instructions)**Note.** All corporations using this part must complete item O and item P, Q, or R.**O** Check the applicable box to indicate whether the corporation is:

1. ☐ A new corporation **adopting** the tax year entered in item F, Part I.
2. ☐ An existing corporation **retaining** the tax year entered in item F, Part I.
3. ☐ An existing corporation **changing** to the tax year entered in item F, Part I.

P Complete item P if the corporation is using the automatic approval provisions of Rev. Proc. 2006-46, 2006-45 I.R.B. 859, to request **(1)** a natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) or **(2)** a year that satisfies the ownership tax year test (as defined in section 5.08 of Rev. Proc. 2006-46). Check the applicable box below to indicate the representation statement the corporation is making.

1. Natural Business Year ► ☐ I represent that the corporation is adopting, retaining, or changing to a tax year that qualifies as its natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) and has attached a statement showing separately for each month the gross receipts for the most recent 47 months (see instructions). I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.

2. Ownership Tax Year ► ☐ I represent that shareholders (as described in section 5.08 of Rev. Proc. 2006-46) holding more than half of the shares of the stock (as of the first day of the tax year to which the request relates) of the corporation have the same tax year or are concurrently changing to the tax year that the corporation adopts, retains, or changes to per item F, Part I, and that such tax year satisfies the requirement of section 4.01(3) of Rev. Proc. 2006-46. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.

Note. If you do not use item P and the corporation wants a fiscal tax year, complete either item Q or R below. Item Q is used to request a fiscal tax year based on a business purpose and to make a back-up section 444 election. Item R is used to make a regular section 444 election.**Q** Business Purpose—To request a fiscal tax year based on a business purpose, check box Q1. See instructions for details including payment of a user fee. You may also check box Q2 and/or box Q3.

1. Check here ► ☐ if the fiscal year entered in item F, Part I, is requested under the prior approval provisions of Rev. Proc. 2002-39, 2002-22 I.R.B. 1046. Attach to Form 2553 a statement describing the relevant facts and circumstances and, if applicable, the gross receipts from sales and services necessary to establish a business purpose. See the instructions for details regarding the gross receipts from sales and services. If the IRS proposes to disapprove the requested fiscal year, do you want a conference with the IRS National Office?

☐ Yes ☐ No

2. Check here ► ☐ to show that the corporation intends to make a back-up section 444 election in the event the corporation's business purpose request is not approved by the IRS. (See instructions for more information.)

3. Check here ► ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event (1) the corporation's business purpose request is not approved and the corporation makes a back-up section 444 election, but is ultimately not qualified to make a section 444 election, or (2) the corporation's business purpose request is not approved and the corporation did not make a back-up section 444 election.

R Section 444 Election—To make a section 444 election, check box R1. You may also check box R2.

1. Check here ► ☐ to show that the corporation will make, if qualified, a section 444 election to have the fiscal tax year shown in item F, Part I. To make the election, you must complete **Form 8716**, Election To Have a Tax Year Other Than a Required Tax Year, and either attach it to Form 2553 or file it separately.

2. Check here ► ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event the corporation is ultimately not qualified to make a section 444 election.

Part III Qualified Subchapter S Trust (QSST) Election Under Section 1361(d)(2)*

| | |
|---------------------------------------|--------------------------------|
| Income beneficiary's name and address | Social security number |
| Trust's name and address | Employer identification number |

Date on which stock of the corporation was transferred to the trust (month, day, year) ►

In order for the trust named above to be a QSST and thus a qualifying shareholder of the S corporation for which this Form 2553 is filed, I hereby make the election under section 1361(d)(2). Under penalties of perjury, I certify that the trust meets the definitional requirements of section 1361(d)(3) and that all other information provided in Part III is true, correct, and complete.

Signature of income beneficiary or signature and title of legal representative or other qualified person making the election

Date

*Use Part III to make the QSST election only if stock of the corporation has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation. The QSST election must be made and filed separately if stock of the corporation is transferred to the trust **after** the date on which the corporation makes the S election.

Part IV Late Corporate Classification Election Representations (see instructions)

If a late entity classification election was intended to be effective on the same date that the S corporation election was intended to be effective, relief for a late S corporation election must also include the following representations.

- 1** The requesting entity is an eligible entity as defined in Regulations section 301.7701-3(a);
- 2** The requesting entity intended to be classified as a corporation as of the effective date of the S corporation status;
- 3** The requesting entity fails to qualify as a corporation solely because Form 8832, Entity Classification Election, was not timely filed under Regulations section 301.7701-3(c)(1)(i), or Form 8832 was not deemed to have been filed under Regulations section 301.7701-3(c)(1)(v)(C);
- 4** The requesting entity fails to qualify as an S corporation on the effective date of the S corporation status solely because the S corporation election was not timely filed pursuant to section 1362(b); **and**
- 5a** The requesting entity timely filed all required federal tax returns and information returns consistent with its requested classification as an S corporation for all of the years the entity intended to be an S corporation and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the tax years, **or**
- b** The requesting entity has not filed a federal tax or information return for the first year in which the election was intended to be effective because the due date has not passed for that year's federal tax or information return.

Exhibit 3: Form 8832 – Entity Classification Election

Entity Classification Election► Information about Form 8832 and its instructions is at www.irs.gov/form8832.

| | | |
|------------------------------|--|--------------------------------|
| Type or Print | Name of eligible entity making election | Employer identification number |
| | Number, street, and room or suite no. If a P.O. box, see instructions. | |
| | City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code. | |

- Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41
☐ Relief for a late change of entity classification election sought under Revenue Procedure 2010-32

Part I Election Information**1 Type of election** (see instructions):

- a** ☐ Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
b ☐ Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

- ☐ **Yes.** Go to line 2b.
☐ **No.** Skip line 2b and go to line 3.

2b Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

- ☐ **Yes.** Go to line 3.
☐ **No.** Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?

- ☐ **Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
☐ **No.** You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:

- a** Name of owner ►
b Identifying number of owner ►

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

- a** Name of parent corporation ►
b Employer identification number ►

6 **Type of entity** (see instructions):

- a** ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.
- b** ☐ A domestic eligible entity electing to be classified as a partnership.
- c** ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
- d** ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
- e** ☐ A foreign eligible entity electing to be classified as a partnership.
- f** ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ►

8 Election is to be effective beginning (month, day, year) (see instructions) ►

9 Name and title of contact person whom the IRS may call for more information

10 Contact person's telephone number

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

[illegible]

11 Provide the explanation as to why the entity classification election was not filed on time (see instructions).

[illegible][illegible]